ECONOMIC COMMISSION FOR EUROPE

COMPETING IN A CHANGING EUROPE

Opportunities and Challenges for Trade and Enterprise Development in a Changing Europe





UNITED NATIONS

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Note

This volume brings together contributions and research papers prepared by some of the speakers and participants of the Executive Forum on "Competing in a Changing Europe", held in May 2004, as well as by the secretariat of the United Nations Economic Commission for Europe (UNECE). These contributions – which were written after the event and thoroughly updated in 2006 – reflect the thinking that the Forum helped generate and are of continued policy relevance.

The Forum was organized under the auspices of the Committee for Trade, Industry and Enterprise Development (CTIED) – since renamed the Committee on Trade – of the UNECE in cooperation with the Regional Bureau for Europe and EECCA (RBEC) of the United Nations Development Programme (UNDP).

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Foreword

Competing in today's changing Europe means participating in international supply chains, which impose complex product specifications and short shipping and processing times. In order to benefit from these networks, firms depend on simplified regulatory frameworks and strict quality standards, as well as customs procedures that are aligned with international practice.

Developing and maintaining an appropriate infrastructure for foreign trade is therefore key, yet it is only part of the equation. Each country also needs to strike an appropriate balance between trade facilitation and trade efficiency. Trade facilitation can be understood as the simplification and coordination of administrative procedures at border crossings while trade efficiency is more broadly the re-organization and automation of the whole supply and payments chain between the buyer and the seller. It would be difficult for a company to implement trade efficiency measures in the absence of trade facilitation measures at the border. At the same time, trade facilitation measures can truly promote a country's competitiveness only when accompanied by trade efficiency measures at a company, industry and country level. The work of UNECE in this area – unlike that of other organizations – embraces a wide definition of trade facilitation that includes trade efficiency and gives support and assistance to reforms and innovation that go beyond a country's borders. For example, UNECE promotes electronic business worldwide and the development of standards allowing low-cost software solutions for international transactions.

Through its work on trade facilitation, electronic business, regulatory frameworks and trade standards, UNECE makes a concrete contribution to the efforts of its member States to shape appropriate strategies for competing in a changing Europe, in the context of a well-functioning international trade infrastructure. I hope that the present volume can be instrumental in achieving this goal, within the context of a renewed European political and economic landscape.



Mr. Marek Belka
Executive Secretary
United Nations Economic Commission for Europe

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List of Abbreviations

AC	*Acquis communautaire*
APEC	Asia-Pacific Economic Cooperation
BAFTA	Baltic Agricultural Free Trade Agreement
CAP	Common Agricultural Policy
CEEC	Central and Eastern European countries
CEFTA	Central European Free Trade Agreement
CEI	Central European Initiative
CIS	Commonwealth of Independent States (comprising all former Soviet Republics with the exception of Estonia, Latvia and Lithuania)
CMEA	Council for Mutual Economic Assistance
CRO	Common Regulatory Objective
CTIED	Committee for Trade, Industry and Enterprise Development
DSL	Digital subscriber line
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EDI	Electronic data interchange
EEA	European Economic Area
EEC	European Economic Community
EECCA	Eastern Europe, the Caucasus and Central Asia
EFTA	European Free Trade Area
EIB	European Investment Bank
ENI	European Neighbourhood Initiative
ENP	European Neighbourhood Policy
EU	European Union
EU-10	Countries that joined the EU in May 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia
EU-15	Founding members of the EU and countries that joined before May 2004: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, United Kingdom of Great Britain and Northern Ireland
FAO	Food and Agriculture Organization
FDI	Foreign direct investment
FTA	Free Trade Agreement

GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GUAM	Georgia, Ukraine, Azerbaijan and Moldova
ICT	Information and communication technologies
ISO	International Organization for Standardization
ISDN	Integrated Services Digital Network
IT	Information technology
ITN	Innovative Trade Network
ITU	International Telecommunications Union
KEP	Know-how Exchange Program
MNCs	Multinational companies
MRA	Mutual Recognition Agreement
NAFTA`	North American Free Trade Agreement
NGO	Non-governmental organization
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
PCA	Partnership and co-operation Agreement
PSTN	Public switched telephone network
R & D	Research and development
ROCE	Interest and taxes relative to total capital employed
RTA	Regional trade agreements
SAA	Stabilization and Association Agreement
SACU	Southern African Customs Union
SAD	Single Administrative Document
SAP	Stabilization and Association Process
SDoC	Supplier's Declaration of Conformity
SEE	South-East Europe
SEECP	South-East European Co-operation Process
SEF	Annual CEI Summit Economic Forum
SME	Small and medium-sized enterprise
SOHO	Small office – home office
TBT	Technical barriers to trade
TIM	Telecommunications, informatics and media
UNECE	United Nations Economic Commission for Europe
WCO	World Customs Organization
WTO	World Trade Organization
xDSL	Generic digital subscriber line

Introduction

The accession of eight Central and Eastern European transition countries and two Mediterranean countries to the European Union (EU) on 1 May 2004 was the most significant enlargement in scope and diversity in the history of the EU. The enlargement brought over 75 million more people into the EU, thus enlarging the scope of its Single Market and enhancing stability and prosperity in the region. The EU enlargement is one of many changes that have taken place and continue to develop in the European trading environment, in the form of regional initiatives that aim at promoting common responses to shared challenges.

The papers presented here address some of the main problems coming from the new European trading environment and offer insight into the policy options and business strategies that can help sustain competitiveness in a changing Europe. They offer a valuable variety of views – coming from governmental bodies, the business community, trade associations, international organizations, the academic community and non-governmental organizations (NGOs) involved in trade issues and enterprise development.

This book is divided into three parts, which focus on the diverse issues that are of concern to business executives and policymakers throughout and beyond the enlarged European Union.

Part I – **"Competing in a Changing Europe"** – outlines the main issues of the new Europe in the context of the enlargement and of EU policies for their "new neighbours".

The first paper presents the enlargement as a unique opportunity for economic integration in the region. It describes the EU's emerging relationship with its new neighbours and investigates the potential economic impact of the European Neighbourhood Policy, both for the EU itself and for its neighbours, in particular the countries of Eastern Europe, the Caucasus and Central Asia (EECCA) and of South-East Europe (SEE). It seeks to develop an answer to the question as to whether the European Neighbourhood Policy (ENP) is sufficiently attractive to induce the Governments in neighbouring countries to adopt economic and governance reforms similar to those that were implemented in the EU-10 during their accession processes.

The second paper explains how the European Free Trade Area (EFTA) member countries responded to the changes brought about by the enlargement. It presents two case studies – trade in marine products and the financial contributions of EFTA to the EU-10.

The third paper illustrates two initiatives involving South-East European countries: the South-East European Cooperation Process (SEECP) and the Central European Initiative (CEI). The SEECP could make an effective contribution to the integration of South-Eastern Europe in regional and global trade networks by promoting regional projects for infrastructure modernization (roads, railways, energy, water management, telecommunications) and by encouraging its members to do away with barriers to regional trade in goods and services. The CEI focuses on specific, project-oriented activities such as technical cooperation and development programmes to support growth and institutional and economic development, through the funds at its disposal. The close cooperation between the CEI and the European Bank for Reconstruction and Development (EBRD) shows that the cooperation between regional financial institutions and regional organizations can be especially productive. It considerably widens the potential of projects for transferring know-how because other countries in the region (apart from the project country itself) can be involved as observers in the project development and directly benefit from best practices and lessons learned.

The fourth paper describes the main elements of the Free Trade Agreement (FTA) signed by Georgia, Ukraine, Azerbaijan and Moldova (GUAM) on 20 July 2002, which sets out the framework for free movement of goods and services among the participating parties, to promote economic growth and sustainable development in the region.

Part 2 addresses the issue of **"Integrating Regional Markets: Trade Facilitation and ICT"**.

The first paper shows how information and communication technologies (ICT) allow an efficient utilization of resources and lead, consequently, to faster productivity and Gross domestic product (GDP) growth. It highlights developments in information and communication technologies markets in the Central and Eastern European countries prior to their accession to the EU in May 2004. It also explores the role these developments played in these

countries' growth and structural change, drawing policy implications that may be relevant for the EU-10 as well as for the EU's new neighbours.

The second paper explores telecommunications from a different angle that of the products used in telecommunications networks (e.g. personal computers, peripherals and cellular phones). These products are "true globals", designed and manufactured for a world market. However, regulatory requirements can differ considerably in the most important end markets, which result in greater costs for manufacturers and greater delays in getting products on the markets. This paper describes alternative and streamlined methods for regulatory product approval.

The third paper addresses the application of ICT to trade facilitation. As the EU borders moved outwards to those of the EU-10, all EU control procedures had to be replicated. This created two twin priority objectives: the coordination of security policy inside the European Community (EC) and the involvement of the business community in a public-private partnership. The paper describes a concrete industry initiative, the Innovative Trade Network (ITN) for trade facilitation and trade security, which allows all companies and traders to work internationally with Governments, agencies and industry stakeholders to create "end-to-end" global supply-chain systems – from manufacturer, to ports of entry, to consumers – that focus on sound business models, facilitate trade and improve security.

The fourth paper addresses the last – and crucial – element of global supply chain systems: cross-border payments. The countries of the European Union have independently created a patchwork of parallel, incompatible payment networks, especially because the majority of payments have always been – and continue to be – domestic. The net result is that cross-border payments are slow and expensive. Moving from cash to cashless commercial payments could therefore lead to large savings. The experience of VISA – an international association of banks, uniting more than 5,000 banks in Europe, and 21,000 worldwide – can be a source of relevant best practice in this area.

Part 3 focuses on **"Sustainable Agriculture and the International Food Supply Chains"**. It discusses the consequences of EU enlargement for the agri-food sector, in particular for EU candidate countries. The papers in this section concur that trade diversion effects will be limited. In the long term,

some benefits could accrue to EU candidates, mainly in the form of a rising demand as a result of higher income levels.

To access the highly competitive EU market, the new neighbours will need to adopt and implement EU quality standards, which will add additional costs on their procedures. However, these investments in higher quality may also open up other export markets, even outside of the EU.



Competing in a Changing Europe

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Chapter 1.1

The Economics of the "European Neighbourhood Policy": An Initial Assessment

Ms. Susanne Milcher, Poverty and Economic Development Specialist, and Ben Slay, Director, Bratislava Regional Centre, United Nations Development Programme (UNDP), Regional Bureau for Europe and Commonwealth of Independent States

The May 2004 accession of the EU-10 to the EU brought deep changes to Europe's political economy, both vis-à-vis the EU-10 and in terms of the EU's "new neighbours". In that same month, the European Commission formally presented the European Neighbourhood Policy (ENP) strategy paper, setting out a new framework for relations and financial support for the neighbourhood countries.[1] The former European Commission President Romano Prodi described the goal of the ENP as seeking to create a "ring of friends" around the EU by offering close cooperation from political dialogue to economic integration. The initiative will allow neighbours to participate in major EU policies and programmes, and ultimately in the EU Single Market. In this way, ENP participants are expected to form a relationship with the EU similar to that of the European Economic Area (EEA) members, such as Norway, Iceland, and Liechtenstein.

This paper describes the general framework of the EU's emerging relationship with its new neighbours and investigates the potential economic impact of the ENP, both for the EU itself and for its neighbours. It seeks to answer the question as to whether the ENP is sufficiently attractive to induce

[1] Verheugen, G. (2004).

the governments in neighbourhood countries to adopt (or accelerate the adoption of) economic and governance reforms similar to those that were implemented in the EU-10 during their accession processes. This task is complicated by the fact that the ENP is not scheduled to go into effect until 2007. However, as of 2005 it seems clear that incentives seem likely to be the ENP's weak point. While "a significant degree of integration" for non-EU members is a goal, the ENP is intended to be an alternative to accession.[2] This raises the question of whether the ENP offers a payoff that is large enough to elicit more rapid reforms and harmonization with the EU legislation. What will be the benefits to ENP countries, beyond being in a "neighbourhood"?

Formally, the ENP is both larger and smaller than the questions addressed in this paper. The ENP is larger in the sense that it addresses the North African and Middle Eastern countries that are engaged in the Euro-Mediterranean Partnership (Barcelona Process).[3] The ENP is also larger in the sense that it seeks to map out deep changes in the EU's development cooperation framework for these countries, in order to simplify and better coordinate the panoply of EU technical assistance instruments applied to these countries.

This paper does not go into these details. By contrast, it focuses on the application of the logic of the ENP – particularly its "market access and support for market reforms" promise that was intrinsic to the successful economic transitions of the EU-10 – to the economies of the Western EECCA and the Caucasus that are the foci of the ENP. The scope of the paper is also broader than the ENP in that it examines many of these economic issues as they apply to the countries of South-East Europe, even though these countries' relations with the EU are outside the scope of the ENP. In particular, the ENP does not apply to Romania, Bulgaria, Croatia and Turkey, because they are candidate countries, nor to the countries of South-East Europe with which the EU is progressively negotiating and implementing Stabilization and Association Agreements (SAAs). This process is explicitly intended to

[2] Verheugen, G. (2004) and Ec. (2004b).

[3] Algeria, Egypt, Israel, Jordan, Lebanon, Libyan Arab Jamahiriya, Morocco, Syrian Arab Republic, Tunisia and the Palestinian Authority.

ultimately lead to their accession. Some aspects of the paper also apply to the Russian Federation, which likewise remains outside of the ENP.[4]

The paper investigates possible impacts of the ENP on economic and political development and income convergence in the participating countries. Section 2 describes the policy's main objectives and principles. Section 3 presents an overview of each country's economic situation and makes sub-regional comparisons. Section 4 presents possible economic and political effects. Section 5 concludes.

1. European Neighbourhood Policy

In March 2003, the Commission proposed a communication on the "Wider Europe Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours" outlining the basic principles of the ENP. In October 2003 the European Council endorsed this initiative and encouraged the Commission to take it forward. The Commission then started explanatory discussions with two of the three East European countries that have had Partnership and Cooperation Agreements (PCAs) in force, Ukraine and Moldova. This led to the development of the strategy paper outlining the ENP's main principles that was released in May 2004.

The ENP has three main purposes. First, it seeks to surround the enlarged EU with a "ring of friends" who share the EU's values and pursue security and other foreign policies that are broadly consistent with those of the EU.

Second, in order to do this, the ENP will offer these countries significant improvements in access to the Single Market and expanded technical assistance. In this way, the ENP seeks to offer its neighbours the kind of "market access for reform" grand bargain that was instrumental in the dramatic improvements in governance institutions that the EU-10 experienced during the accession processes of the 1990s.

[4] The EU's partnership with the Russian Federation is to be developed within the framework of the "common European economic space" announced at the Russo-European Summit in May 2002 (May, 2004).

The experience of the EU-10 suggests that the largest benefits of convergence towards European standards can come in the form of foreign direct investment (FDI), which can be attracted by geographic proximity and preferential access to the single market. This FDI can have unparalleled advantages in terms of restructuring and modernizing unreformed manufacturing, energy, and financial sectors. The EU also seeks in this way to moderate the potentially negative effects of the new Schengen borders on its new neighbours.

Third, the ENP implicitly recognizes that the further expansion of the EU, in terms of the accession of new members from EECCA, is not expected. In contrast to the Stabilization and Association Processes (SAPs) now on-going in South-East Europe – which are seen as preparing these countries for eventual EU membership – the ENP is to be an *alternative* to EU membership. Such an option may seem unpalatable to the countries of the western EECCA (particularly Ukraine) and the Caucasus that ultimately aspire to full EU membership. This underscores the importance of ensuring that the benefits of ENP membership – and the process of attaining them – are sufficiently attractive.

National action plans drawn up by the European Commission (EC) and new neighbourhood countries will be the ENP's main operational framework. These plans will cover five-year periods and are to be renewable by mutual consent. They are to build on existing cooperative frameworks, such as the bilateral PCAs with Ukraine and Moldova that were signed in 1994 and went into force in 1998. The PCAs will continue to form the legal basis for relations; the ENP action plans will set out the framework for their realization. (In South-East Europe, the relations between the EU and partner countries will be conducted within the framework of accession and the stabilization and association agreements.) At the St. Petersburg Summit in May 2003 the EU and the Russian Federation decided to develop four common spaces: a common economic space; a common space for freedom, security and justice; a common space of cooperation for external security; and a common space for joint research and education. Energy is a key element. In the Russian case, the

ENP is to serve as the legal framework for deepening and structuring these bilateral agreements and programmes.[5]

In addition to performing a host of functions,[6] the action plans are to describe the processes by which the new neighbours will attain preferential access to the single market. The plans are intended to ultimately bring most of EU trade with the new neighbours under the EU common external tariff regime. They will also seek to ensure that trade flows during this transition are governed by the principles of the World Trade Organization (WTO). For example, by facilitating convergence with EU food safety regulations, the national action plans should improve prospects for the new neighbours' agricultural exports on the single market. Given the importance of foodstuffs in the commodity composition of their exports,[7] this combination of liberalized market access and technical assistance could yield extensive benefits for the neighbourhood economies.

The creation of the European Neighbourhood Instrument (ENI), which is to be put in place by 2007 (in time for the start of the EU's new 2007-2013 financial perspective), will be the ENP technical assistance instrument. It will also be a key incentive for inducing neighbouring country participation in the ENP. This new financial instrument, which will support cross-border and regional cooperation projects, is slated to replace some existing technical assistance instruments (e.g. TACIS programming) while better complementing others (e.g. INTERREG). In principle, the ENI will facilitate funding applications under a single administrative framework for cross-border programmes that would both span and fall within the EU's new frontiers.

[5] A PCA was also signed with the Russian Federation in 1994, and went into effect in 1997.

[6] These include: (1) promoting political cooperation (with a particular emphasis on security issues); (2) providing the new neighbours with improved access to EU programmes in the areas of education and research and development, and to European infrastructure networks in the fields of energy, transport and telecommunications and environment; and (3) justice and home affairs, particularly as concerns issues of border management, migration, trafficking in human beings, drugs and arms, and organized crime.

[7] See Aaslund and Warner (2004) for more on this point.

For the period 2007-2013, the EC intends to increase substantially the annual amounts to be allocated to the ENI (relative to the 266 million euros in comparable technical assistance programmes available for the period 2004-2006).[8] However, if this is to be the only incentive in place, the ENP will most likely remain a very modest development cooperation mechanism, relative to the development challenges of the new neighbours. This underscores the importance of the ENP's prospects for fostering the "market access for reform" grand bargain that the new neighbours would need to attract transformative amounts of FDI.

2. Economic situation of the "new neighbours"

Gross domestic product (GDP) levels, trends, and compositions vary sharply among the EU's new neighbours. In the EECCA economies it significantly exceeded EU averages during the period 2000-2004 (figure 1), with particularly high growth rates noted in Armenia and Azerbaijan, but also in Ukraine. Strong growth is noted across virtually all components of domestic demand as well as exports. Fiscal accounts in these economies have generally in balance, if not in surplus. In some countries (the Russian Federation and Ukraine), these fiscal surpluses have also been accompanied by external surpluses. By contrast, the economies of the EU-10 and South-East Europe typically exhibited large external deficits that have been financed by equally large inflows of FDI, portfolio investments and bank lending. Fiscal deficits in the Central European economies also expanded during this time, earning these countries warnings from the EC (if not financial markets).

Despite the high growth rates, distances to the EECCA economies' 1990 GDP levels remain large. Although statistical problems and extensive structural change make such "before and after" comparisons problematic, the Russian Federation at the end of 2004 was still some 18 per cent below its 1990 GDP level. Large gaps were likewise reported for Ukraine (35%), Moldova (37%), and Georgia (40%).[9] This underscores the fact that the post-1999 recovery experienced in these countries is "recovery growth", based primarily on the employment of previously idle human and physical capital.

[8] EC. (2004b).

[9] World Development Indicators database, adjusted for estimates of 2004 data.

Without inflows of fresh capital and the technological transfers they embody, this growth may not be sustainable.

Likewise, although the new neighbours' fiscal (and in some cases external) surpluses are sometimes described as signs of health, they can also be seen as reflections of underdeveloped financial systems and unfriendly investment climates. While showing the benefits of strong economic growth, budget surpluses also reflect shallow financial systems that are unable to channel domestic savings into government debt at affordable (for the budget) interest rates. Fiscal and external surpluses also reflect foreign investors' unwillingness to invest in these countries, necessitating either current account surpluses (e.g. Russian Federation and Ukraine) or significant inflows of concessionary lending to finance current account deficits (e.g. Armenia, Georgia, Moldova).

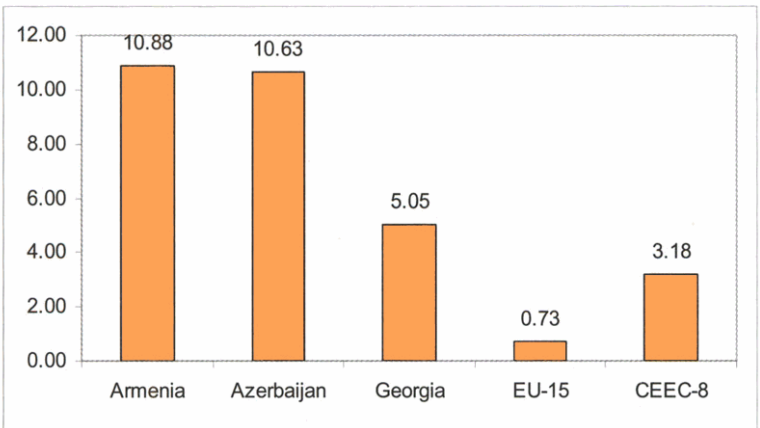
By contrast, the current account deficits (figure 2) reported in most of the EU-10 and candidate countries (Bulgaria, Croatia, Romania) are smaller than those recorded in the Caucasus and Moldova. They have generally been financed by substantial inflows of FDI and equity portfolio investments.[10] Such inflows are signs of health and improving international economic competitiveness. They largely result from convergence in regulatory, governance, and business climates towards EU standards in these countries — which, in turn, is a reflection of their progress in EU accession and integration. Prior to the May 2004 expansion, EU-15 countries accounted for 70-80 per cent of exports from Poland and Hungary.

The EU shares of Czech and Slovak exports were somewhat smaller, owing to the continuing relatively large role of Czech-Slovak exports. As Figure 3 shows, exports to the EU-15 account for more than 50 per cent of the total for from Bulgaria, Croatia, and Romania. Can the ENP deliver the same benefits to Europe's new neighbours?

[10] The relatively large FDI inflows shown for Armenia, Georgia, and Moldova in figure 2 are somewhat misleading. They tend to reflect one-off privatization sales and debt-for equity swaps, and are small relative to these countries' current account deficits.

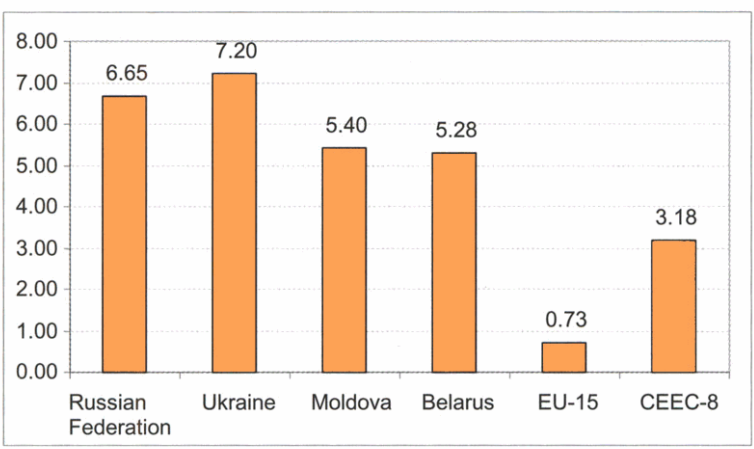
Figure 1: Average annual GDP growth (percentage), 2000-2003

Figure 1a: Caucasus



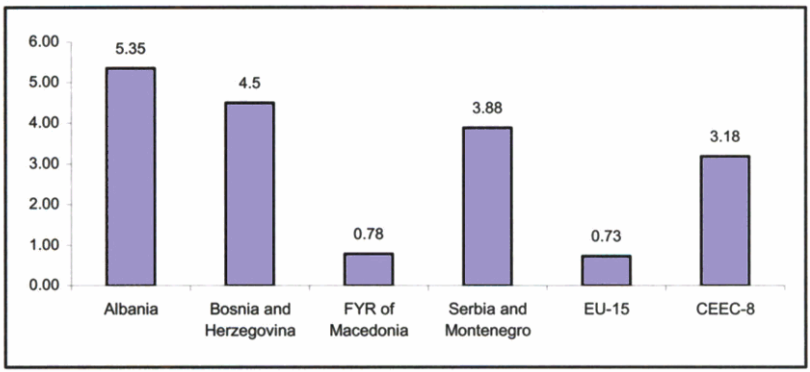
Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

Figure 1b: Western EECCA



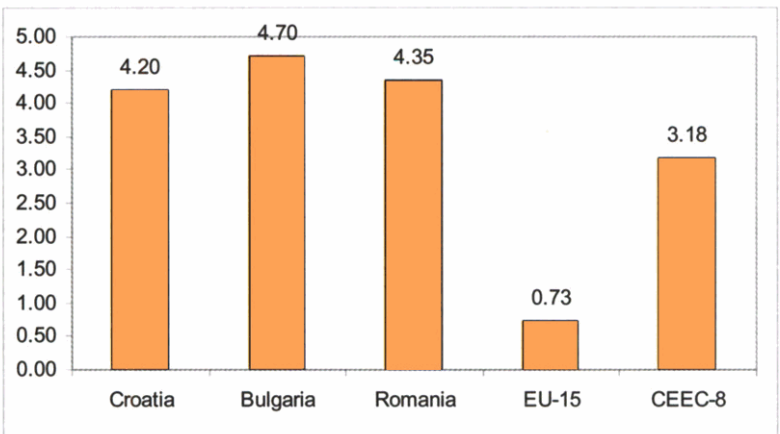
Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

Figure 1c: South-East Europe



Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

Figure 1d: Candidate countries



Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

Convergence toward EU regulatory standards may not matter much if the ENP does not significantly improve the new neighbours' access to the Single Market. Existing trade regimes are not particularly promising in this respect: the PCAs that govern the new neighbours' trade with the EU "are little but codification of WTO principles for non-WTO members".[11] At present, EU export shares of the EECCA countries are significantly lower than those of the EU-10 and the South-East European countries (figure 3), even after controlling for structural reform and distance from the EU market. For example, Ukraine's exports to the EU-15 fail to reach 20 per cent of total exports.

Aaslund and Warner argue persuasively that these low shares can be attributed to these countries' lack of preferential access to the EU's single market.[12] The EU's effective protection is especially high for agricultural goods, textiles, chemicals, and steel – goods that play a particularly large role in the commodity composition of EECCA exports. In this sense, EU trade policies create obstacles for export and GDP growth for EECCA countries. By the same token, significant improvements in access to the single market could have a major positive impact on the new neighbours' prospects for exports and export-related FDI.

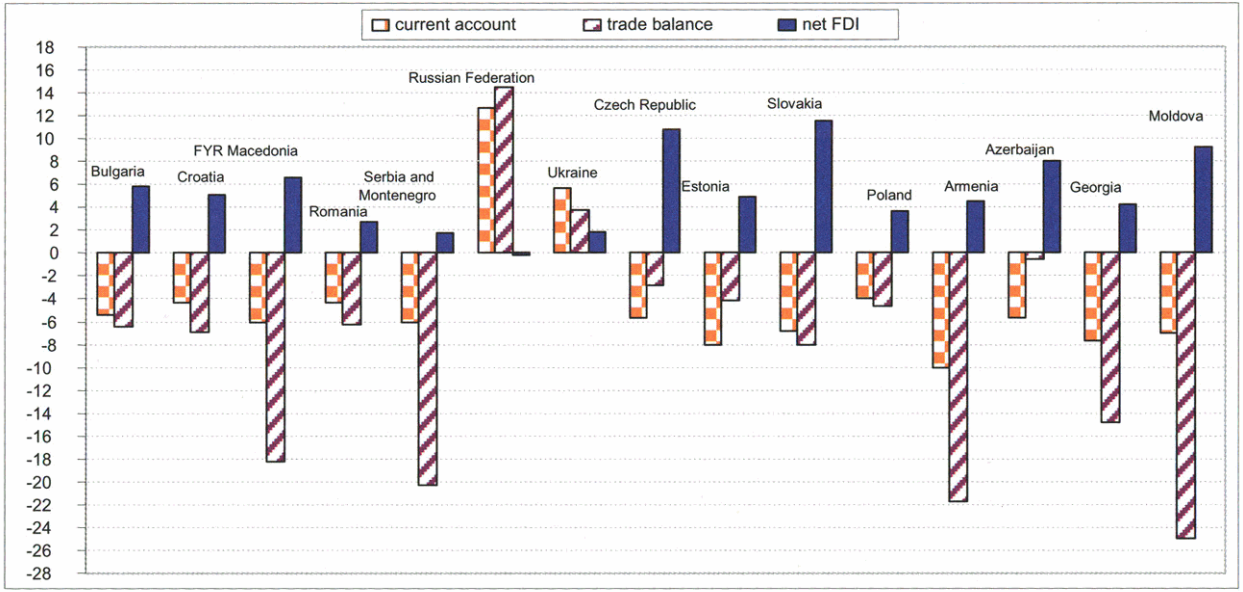
The situation is somewhat different in the Russian Federation and Azerbaijan, owing to the large role of oil and gas (which are not subject to extensive protection) in their commodity composition of exports. The deployment of the Baku-Tbilisi-Ceyhan oil pipeline in 2004 will increase Azerbaijan's importance as an energy supplier for the EU. The Russian Federation is the EU's fifth largest trading partner (after the United States, Switzerland, China, and Japan). The enlarged EU is the Russian Federation's largest trading partner, accounting for more than 50 per cent of its total trade; some 40 per cent of Europe's gas supplies come from Russia.[13] Likewise, oil exports make Azerbaijan the EU's largest trading partner in the Caucasus,

[11] Aaslund and Warner (2004).

[12] Aaslund and Warner (2004).

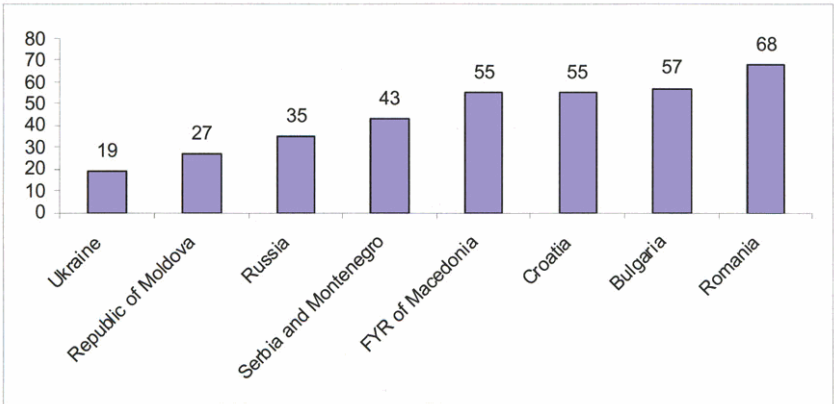
[13] EC. (2004d).

Figure 2: Current account, trade balance and net FDI (percentage of GDP), average 2000-2002



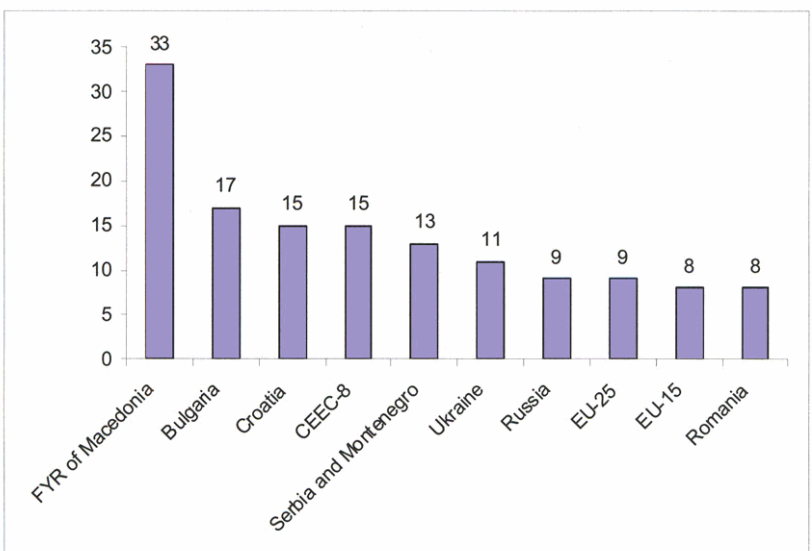
Source: World Development Indicators 2004.

Figure 3: Exports to EU-15 (percentage of total exports), 2003



Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

Figure 4: Average annual unemployment rate (LFS), 2000-2003



Source: CISSTAT 2003. Leon Podkaminer et al., 2004, Transition Countries on the Eve of EU Enlargement, WIIW.

although some studies suggest that even in Azerbaijan, foodstuffs, cotton, and textiles could play a large role in the country's export basket.[14]

FDI-led restructuring of manufacturing, energy, and finance sectors, as was the case in the Central European countries, can be a second important determinant of integration. Since 2000, expanded privatization programmes in South-East Europe have attracted significant FDI from EU-focused multinationals. FDI inflows have shifted from the EU-10 to South-East Europe.[15] In contrast, most of the FDI flowing into the Western EECCA countries comes from the Russian Federation, which reported relatively large outward FDI flows during the 2001-2004 period.

As was earlier the case in the Central European economies, recovery growth and elements of FDI-led industrial restructuring are now generating improvements in labour productivity in both the EECCA and South-East European countries. When combined with slow or negative labour force growth and (in some cases) declining employment, this labour productivity growth has been accompanied by high unemployment rates in most "new neighbour" countries (figure 4) – particularly in the Western Balkans.[16] Despite the current high growth rates, these countries continue to suffer from inadequate business infrastructure, difficult regulatory climates, elements of corruption in public administration,[17] high unemployment rates, and inadequate human insecurity.

3. Possible impact of the European Neighbourhood Policy

Can the ENP help to replicate the Central European transition successes in the new neighbour countries? Will the "market access for reform" bargain implied by the ENP lead to dramatic improvements in market access, export-oriented FDI, restructuring and modernization?

[14] Centre for Economic Reforms (2005).

[15] Podkaminer, L. et al. (2004).

[16] Mizsei and Maddock (2005).

[17] cf. table 1, page 15.

Optimists on these points must face two key questions. First, the neighbourhood countries are more heterogeneous and poorer than the Central European countries. This is apparent both in economic issues (per capita GDP levels, overall size and structural characteristics) and political terms. A successful "market access for reform" bargain for Moldova would necessarily look different from one for the Russian Federation. Second, the ENP is unlikely to be seen as a fully satisfactory substitute for eventual EU membership – particularly by reformist Governments (e.g. Ukraine after the "Orange Revolution") who are most likely to desire accession. Both of these factors are likely to weaken to stabilizing effect of the "European anchor".

For the "market access for reform" bargain to work, the economic benefits of the ENP must be seen to be positive and significant. Previous experiences with the extension of the Single Market to non-EU countries, such as Norway, Switzerland, or Liechtenstein, offer hope in this respect. However, the neighbourhood countries have lower quality infrastructure, lower per-capita GDPs, and much greater political risk. This increases the importance of other elements of the ENP, particularly financial assistance and infrastructure development (especially in the energy and transport sectors).[18] Likewise, European integration for these economies could have some downsides, particularly in terms of trade diversion, but also (particularly for Azerbaijan) the possibility of further specialization in the export of raw materials that can mean heightened vulnerability to terms-of-trade shocks, as occurred in 1998.

3.1. Economic policy, trade and the Single Market

The ENP could bring substantial efficiency and welfare gains to neighbouring countries, via liberalized access to the single market. Legal changes in the areas of customs and financial services should promote trade facilitation and business creation. Better market access, combined with enhanced dialogue and cooperation on social and employment policies, could encourage reforms directed at reducing poverty and increasing the effectiveness of social assistance. The bilateral EU association agreements concluded with the Central European countries in 1991, which provided asymmetric access to the Single Market for Central European exporters, may

[18] Dodini, M. and Fantini, M. (2004).

be instructive in this respect. In addition to encouraging rapid growth in trade overall and towards the EU in particular, the association agreements (combined with ambitious privatization programmes) promoted significant FDI inflows, attracted by "export platform" possibilities.[19]

While this pattern seems to be taking hold in South-East European countries now negotiating for EU membership, it may be less replicable in the countries of the western EECCA and the Caucasus. Thanks to their SAP agreements with the EU, the South-East European countries already enjoy preferential access to the Single Market (relative to EECCA countries). During the past few years the South-East European countries have attracted significant FDI inflows – many of which came from EU-focused companies. However, recent increases in FDI in the Western Balkans appear to be largely due to progress in privatization programmes. This also means that FDI in the Western Balkans is likely to involve restructuring and hence job losses.[20] By contrast, most FDI in the EU-10 is of the green field variety, and hence more likely to be job-creating. The South-East European economies have the opportunity to experience this phase in the next few years.

In Romania, thanks largely to FDI the share of machinery and transport equipment in total exports (22%) now exceeds the share of textiles and clothing in total exports (20%).[21] On the other hand, intra-Balkan trade remains heavily dependant on local developments, since intra-regional trade accounts for a large share of exports in this sub-region.

By contrast, privatization in EECCA countries has generally been focused on sales to domestic investors (see figure 5), and Russian capital or "round-tripping" domestic capital typically plays a large role in the relatively small FDI that has come in. Perhaps for this reason, significant changes in the commodity composition of exports have yet to be registered. In Moldova, for example, food products and textiles account for almost 50 per cent of total exports, while mineral products and machinery and equipment take up almost

19 Martin, C. and Turrion, J. (2001).

20 Mizsei and Maddock (2005).

21 Podkammer, L. et al. (2004).

40 per cent of total imports.[22] The end of preferential access to markets in Poland and other Central European countries that came with their May 2004 EU membership will result in at least some trade diversion: losses for Ukrainian producers are estimated at about 1 per cent of exports in 2004-2005. Whether improved market access and greater support for market reforms that could come with the ENP will be sufficient to generate a breakthrough in this respect remains to be seen.

The ENP's focus on energy safety and security (as is explained in the *Communication on the development of energy policy for the enlarged European Union, its neighbours and partner countries*) is a potential opportunity for the new neighbours, both energy producers (Russian Federation and Azerbaijan) and energy transporters (Ukraine, Russian Federation, Belarus, Georgia and Azerbaijan).

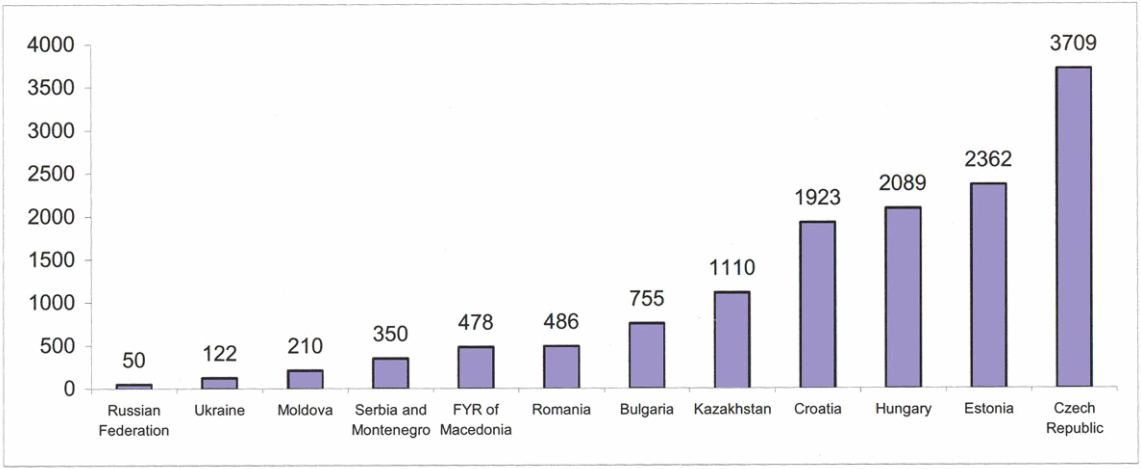
The national action plans will build on existing bilateral or regional energy and transport initiatives, such as the EU-Russia Energy Dialogue, the Inogate Programme dealing with the Caspian basin, the TRASECA transport project, and the South-East Europe Regional Energy Market. These initiatives have helped establish a roadmap for institutionalized partnership, with concrete measures to harmonize the legal and regulatory framework for energy sectors. Increased energy efficiency, the use of renewable energy, and cooperation in energy technologies are also promoted by these programmes.

3.2. Cross-border issues

The ENP seeks to improve the transport infrastructure connecting the enlarged Union with neighbouring countries, to develop the information society (in keeping with the Lisbon Agenda), to include the neighbouring countries in the EU's research area, and to promote good environmental governance in neighbouring countries. This is particularly important in the case of river and other ecosystems that overlap the EU's new eastern frontier, and in light of the new neighbours' inexperience in effective trans-border environmental governance. For example, the Tisza river basin, which connects Hungary, Romania, Slovakia, Ukraine and Serbia and Montenegro, has well-

[22] EIU (2004).

Figure 5: Cumulative FDI inflows per capita 1989-2003, in $US



Source: EBRD (2004) Transition Report update.

preserved rural landscapes, vast complexes of natural forests, and important biodiversity resources. It also suffers from numerous pollution hotspots, declining heavy industry, lagging economic development, high unemployment levels, emerging patterns of regular flooding, and other tensions linked to the legacies of communism and problems of transition. The ENP could facilitate better transnational management of the Tisza river basin.

The HIV/AIDS epidemic that is emerging in the western EECCA countries (particularly in Ukraine and the Russian Federation) – as well as in Estonia – is another serious cross-border challenge that is not addressed in the ENP. Prevalence rates by the end of 2001 in these countries were at about 1 per cent of the adult populations – the level at which the epidemic began to spin out of control in some African countries. (By contrast, prevalence rates in Western Europe at the end of 2001 averaged 0.3 per cent, and were below 0.1 per cent in Central European countries.[23]) The Joint United Nations Programme on HIV/AIDS (UNAIDS) estimated that some 1 million people were living with HIV in the Russian Federation at the end of 2003 and the virus continues to spread rapidly in Belarus and Moldova. In addition to the high prevalence rates already recorded in Estonia, there is evidence that HIV incidence is also growing rapidly in Latvia and Lithuania.[24] HIV/AIDS trends are transboundary and the enlarged EU cannot avoid facing this problem. Instead, it should promote the same values and reforms that helped the EU-10 effectively respond to the HIV/AIDS epidemic. These include democratization, the modernization of state structures, and the empowerment of individuals and NGOs, which have promoted the good governance and the grass-roots social and behavioural changes needed to combat the epidemic.

3.3 Governance

The ENP could help to strengthen political dialogue in the areas of security, conflict prevention and crisis management, border management, migration, visa policies, and organized crime. The ENP offers a possible framework for greater international involvement in Moldova's Transnistria. Likewise, the inclusion of Armenia, Azerbaijan, and Georgia in the ENP could

[23] UNDP, (2004).

[24] Ibid.

increase the EU's role in the potential resolution of the disputes in the Caucasus. In addition to political stability, institutional capacity is key to development. The new neighbours still face major challenges in modernizing state institutions, particularly in terms of decentralization and public administration reform. Imperfections in governance in turn prevent the emergence of the market friendly State structures needed for improved business and investment climates. Major obstacles are associated with taxation systems and high corruption levels (table 1), which generate large informal sectors.

Table 1: Corruption perceptions index*

	1998	*1999*	*2000*	*2001*	*2002*	*2003*
Albania		2.3			2.5	2.5
Bosnia and Herzegovina						3.3
Croatia		2.7	3.7	3.9	3.8	3.7
FYR Macedonia		3.3				2.3
Serbia and Montenegro	3.0	2.0	1.3			2.3
Armenia		2.5	2.5			3.0
Azerbaijan		1.7	1.5	2.0	2.0	1.8
Georgia		2.3			2.4	1.8
Belarus	3.9	3.4	4.1		4.8	4.2
Moldova		2.6	2.6	3.1	2.1	2.4
Russian Federation	2.4	2.4	2.1	2.3	2.7	2.7
Ukraine	2.8	2.6	1.5	2.1	2.4	2.3
Bulgaria	2.9	3.3	3.5	3.9	4.0	3.9
Romania	3.0	3.3	2.9	2.8	2.6	2.8

* Measures perceptions of the degree of corruption as seen by business people, academics and risk analysts. The measure ranges between 10 (highly clean) and 0 (highly corrupt).

Source: Transparency International, www.transparency.org/cpi.

Migration, which can be a key engine of European growth, is now receiving growing attention in the EU. Some studies have found that immigrants in the United States produce 4.5 times more in that country than in their country of origin with the same skill level. They benefit from extra and

more advanced physical capital and capable institutions that allow them to perform at higher levels of productivity.[25] Remittances from migrants can contribute to development in the home country if they are used locally to start-up small enterprises without providing long-term finances.[26] Remittances also make major positive contributions to the balance of payments in virtually all the new neighbour and West Balkan countries, rivalling (if not exceeding) levels of official development assistance (and in some cases, FDI).

4. Conclusion

The impact of the ENP will ultimately depend on its influence on economic development in the new neighbouring countries. So far, it is easier to find reasons for scepticism than optimism. Although the ENP seeks to ease trade restrictions through the implementation of legislative approximation and convergence with EU standards, prospects of access to the EU Single Market seem rather far away. The same would therefore apply to the FDI needed to transform the economies of the western EECCA and the Caucasus. The lack of measures to promote increased labour migration between the new neighbours and the enlarged EU may also be something of a missed opportunity. On the plus side, access to the Single Market could improve significantly under the ENP. Likewise, the new ENI could add more coherence in technical assistance, and provide more financial support for creating capacities for trade infrastructures and institutional and private sector development.

Whether these benefits will be sufficient to push recalcitrant reformers to adopt robustly European policy agendas remains to be seen. Government interest in reforms seems likely to depend largely on eventual prospects for EU membership. The ENP does little to remove fears in this respect. Indeed, its emerging role as substitute for EU membership could make the ENP ineffective — if not counterproductive. It is not clear that the countries of the western EECCA and the Caucasus will be motivated by prospects of an eventual stake in the Single Market, or of some easing of visa restrictions.

[25] Klein, M. (2003).

[26] Ellerman, D. (2004).

Fundamentally, the neighbourhood policy has yet to show what it is meant to be. It could be a modest mechanism for mitigating the unfavourable effects of the enlargement for border regions. It could also be an attempt to motivate a serious "Europeanization", in the sense of political, economic and societal transformation of neighbouring countries. As one observer noted: "the optimist can say that this is a case of a glass half full, rather than half empty. At least the glass has been constructed, it is reasonably transparent, and more can be poured into the container in due course".[27]

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Chapter 1.2

The Evolving European Trade Environment

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1. EFTA as an organization

The enlargement of the EU on 1 May 2004 had a direct effect on EFTA member countries (Iceland, Liechtenstein, Norway and Switzerland). The most important change in EFTA's relationship with the EU was the enlargement of the EU Internal Market, which includes the EU-15, the EU-10 and the three EFTA countries belonging to the European Economic Area (EEA). The enlarged market comprises 28 EEA countries with some 470 million consumers.

The fourth EFTA State, Switzerland, also enjoys a closer trading relationship with the EU-10 through a series of Swiss-EU bilateral agreements. The EFTA countries had FTAs with eight of the ten new EU entrants. These agreements were terminated when they joined the EEA. Some new trade barriers resulted from the enlargement between EFTA and the EU-10, which will be mentioned below.

EFTA is an example of successful trade cooperation between small countries in a globalized economy. This intergovernmental organization was established by the EFTA Convention of 1960. It was based on the premise of free trade as a means of achieving growth and prosperity amongst member countries, as well as promoting closer economic cooperation. The free trade area was made possible because of EFTA's pioneering efforts in developing an operational system of origin certificates for goods. Provisions for the

establishment of free trade areas are in the General Agreement on Tariffs and Trade (GATT, 1947) and the Agreement establishing the (WTO).

EFTA's present free trade system is comprised of the following:

(a) the EFTA Convention (internal trade, 4 countries);
(b) free trade instruments with the EU (25 countries, i.e. the EEA Agreement including Iceland, Liechtenstein and Norway and the bilateral Swiss-EU FTA);
(c) FTAs with partners worldwide (13 countries plus one territory represented by the Palestinian Authority);
(d) Bilateral FTAs with one territory (Faroe Islands).

After the EU, EFTA has the largest network of FTAs, offering its nationals duty-free access to 42 countries and markets of over 750 million people. In 2004, 76.0 per cent of EFTA's trade was covered by FTAs. In absolute terms, EFTA trade accounted for over $366 billion or 2 per cent of world merchandise trade. EFTA's aim is to develop its free trade network further as much as is possible and practical.

Already, about one half of world trade is covered by regional trade agreements. The expansion of WTO membership and the exponential increase in the number of FTAs that are now being negotiated has created new potential free trade partner countries for EFTA, as well as for other countries worldwide.

2. History

Developments in European free trade originated with the Organisation for European Economic Co-operation (OEEC, later to become the Organisation for Economic Co-operation and Development, or OECD), set up in 1948 to coordinate the European Recovery Program (Marshall Plan) after the Second World War. One of its basic principles was to develop intra-European trade by reducing tariffs and other barriers to trade. In 1957, negotiations were initiated

within the OEEC[28] to set up a European Free Trade Area. After the Treaty of Rome was signed in 1957, establishing the European Economic Community (EEC), the so-called "Maudling Committee" pursued the negotiations. The talks were unsuccessful and two years later seven countries, led by the United Kingdom and including Austria, Denmark, Norway, Portugal, Sweden and Switzerland, founded EFTA in 1960. They later became known as the "Outer Seven", the six Common Market (EEC) countries being known as the "Inner Six" (France, Federal Republic of Germany, Italy, Belgium, the Netherlands and Luxembourg). This left four OEEC countries without free trade arrangements, Greece, Iceland, Ireland and Turkey (Finland and Spain were not members of the OEEC). The major aim of the EFTA Convention was to remove trade barriers between the members of the OEEC, including the EEC.

Over the years, EFTA's membership changed as follows: Finland became an associate member of EFTA in 1961 (EFTA 8). Iceland became a member in 1970 (EFTA 9). In 1972, the United Kingdom and Denmark left EFTA to join the EEC with Ireland (EFTA 7). In 1985, Portugal left EFTA to join the EEC with Greece and Spain (EFTA 6), Finland became a full member of EFTA in 1986 and Liechtenstein joined in 1991 (EFTA 7). In 1995, Austria, Finland and Sweden left EFTA to join the EU (EFTA 4).

EFTA's development can basically be divided into three periods: Consolidation, Integration and Outreach. The first period refers to the development of free trade among the EFTA countries, the second refers to economic integration with the EU and the third refers to EFTA's so-called "Third Country Policy", which covers the conclusion of FTAs with non-EU countries.

3. Consolidation

Among EFTA's main original aims was the liberalization of trade among its members, as well as with the six Common Market countries, without subscribing to the commitments of a political character in the Treaty of Rome

[28] The original 17 OEEC participants were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, the United Kingdom, and later, the Federal Republic of Germany.

establishing the EEC. EFTA achieved full free trade internally in industrial products in 1967.

3.1 Integration

The entry of two EFTA countries into the EEC in 1972, the United Kingdom and Denmark, prompted the conclusion of FTAs between EFTA countries and the EEC. This was a major aim of the EFTA Convention. Free trade was reached between EFTA and the EEC in industrial products in 1977.

The conclusion of EFTA's FTAs with the EEC in the early 1970s was celebrated as a major step towards the original goal of integrating the two trade areas of Western Europe. They provided the basis for closer and more substantial cooperation between EFTA and the EEC. Another major step towards European integration was the conclusion of the Agreement on a EEA in 1992 between the seven EFTA countries and the 12 EEC countries. Switzerland later rejected the EEA Agreement and three of the seven EFTA countries later joined the EU. Switzerland subsequently concluded bilateral agreements with the EU in 1999 and in 2004.[29]

[29] Switzerland signed seven bilateral agreements with the EU on 21 June 1999 (Bilaterals I) on the free movement of persons, trade in agricultural products, public procurement, conformity assessments, air transport, transport by road and rail and the Swiss participation in the 5th Framework Programme for Research. They entered into force on 1 June 2002. Switzerland signed a second set of agreements with the EU on 26 October 2004 (Bilaterals II) on taxation of savings, the co-operation in the fight against fraud, the association of Switzerland to the Schengen *acquis*, participation of Switzerland in the "Dublin" and "Eurodac" regulations, trade in processed agricultural products, the Swiss participation in the European Environment Agency and European Environment Information & Observation Network (EIONET), statistical cooperation, the Swiss participation in the Media plus and Media training programs and on the avoidance of double taxation for pensioners of the Community institutions.

3.2 Outreach

EFTA's Third Country Policy has developed in several overlapping phases, which concentrated at first on Europe, then the Southern Mediterranean and finally the rest of the world.

3.3 Europe

After free trade with the EU had been achieved, EFTA pursued a policy of concluding FTAs with the neighbouring countries of Europe. An agreement was concluded with Spain in 1979 and, after a pause, with Turkey in 1991. The only non-European FTA during this period was with Israel in 1992.

A further wave of new agreements was precipitated by the liberalization of Eastern Europe. The EU concluded the so-called "Europe Agreements" with the Eastern European countries. EFTA concluded FTAs with Czechoslovakia, Poland and Romania in 1992, Bulgaria and Hungary in 1993 and Estonia, Latvia and Lithuania in 1995. These were followed in turn by the Balkan countries, Slovenia in 1995, the former Yugoslav Republic of Macedonia in 2000 and Croatia in 2001. Joint declarations on cooperation, aiming at future free trade negotiations, were signed with Albania in 1992, and Ukraine and Serbia and Montenegro in 2000. For both EFTA and the EU, these agreements represented an important signal for European re-integration.

3.4 Mediterranean

In 1995, the EU initiated the Barcelona Process, offering, inter alia, the progressive establishment of a free trade area with the non-member Mediterranean countries. This prompted a second phase in EFTA's Third Country Policy. FTAs were successfully concluded with Morocco in 1997, the Palestinian Authority in 1998, Jordan in 2001 and Lebanon and Tunisia in 2004. Negotiations were initiated with Egypt in 1998 and a joint declaration on cooperation was signed with Algeria in 2002.

3.5 Beyond Europe and the Mediterranean

The third phase of EFTA's Third Country Policy was initiated in 1998, when Canada proposed the conclusion of an FTA. For the first time, EFTA

decided to negotiate a FTA beyond Europe and the Mediterranean. This would also be the first negotiating partner without a free trade agreement with the EU. Finally this would be the first so-called "second-generation agreement", covering not only goods, but also services and investments.

FTAs were concluded with Mexico in 2000, Singapore in 2002 and Chile in 2003, all second-generation agreements. Negotiations were launched with South Africa and the other four members of SACU, the Southern African Customs Union[30], in 2003. The SACU negotiations are EFTA's first FTA negotiations with least developed countries (Lesotho and Swaziland). Increased trade is likely to further their development. In 2005, free trade negotiations were launched with the Republic of Korea and were scheduled to start with Thailand. Joint declarations on cooperation were signed with the Gulf Cooperation Council (GCC)[31] and Mercosur[32] in 2000.

3.6 Economic perspectives

As a rule, small countries benefit more from FTAs than large diversified economies. On the other hand, these countries have less negotiating leverage in FTA negotiations, because of their small markets. For this reason, the joint cooperative approach of the EFTA countries gives them a much better negotiating position. If markets are lacking in one EFTA country, the slack is often taken up by markets of other EFTA countries. On the export side, Switzerland has strengths in pharmaceuticals, while Norway and Iceland are among the world's largest fish exporters. The combined strength of the EFTA countries makes them a more attractive negotiating partner.

There are several reasons for the recent policy change in many countries worldwide towards concluding FTAs. These will not be discussed in detail here, but among the most important are the many economic benefits arising from such agreements, leading to increases in the standard of living and accelerating economic development.

30 South Africa, Namibia, Botswana, Lesotho and Swaziland.

31 United Arab Emirates, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait.

32 Argentina, Brazil, Paraguay and Uruguay.

Table 1: EFTA's past, present and possible future FTAs

Past FTAs (9)	*Present FTAs (14)*	*Possible future FTAs (11)**
Spain (1979-1985)	Turkey (1991)	Albania (1992)
Czechoslovakia	Israel (1992)	Egypt (1998)
(1992-1993)	Romania (1992)	Canada (1998)
Czech Republic	Bulgaria (1993)	GCC (2000)
(1993-2004)	Morocco (1997)	Mercosur (2000)
Slovakia (1993-2004)	Palestinian Authority	Ukraine (2000)
Poland (1992-2004)	(1998)	Serbia-Montenegro (2000)
Hungary (1993-2004)	The former Yugoslav	Algeria (2002)
Estonia (1995-2004)	Republic of Macedonia	SACU (2003)
Latvia (1995-2004)	(2000)	Republic of Korea (2005)
Lithuania (1995-2004)	Mexico (2000)	Thailand (2005)
Slovenia (1995-2004)	Croatia (2001)	
	Jordan (2001)	
	Singapore (2002)	
	Chile (2003)	
	Lebanon (2004)	
	Tunisia (2004)	

* Date of joint declaration on cooperation or launch of FTA exploratory talks/negotiations, whichever is the latest.

EFTA's free trade policy over the last 45 years has greatly contributed to the economic strength of its members. For example, the combined GDP of the EFTA countries in 2004 was $622 billion, placing them in ninth place in the world, before the Russian Federation for example. Their per capita GDP is among the highest in the world, with Norway, Iceland and Switzerland and holding third, sixth and eighth places.[33] Inflation and unemployment rates are among the lowest anywhere.

[33] World Bank, GDP per capita (PPP) in 2003. Figures for Liechtenstein are not available.

EFTA is the EU's second largest trading partner after the US, placing it above China, Japan and the Russian Federation. EFTA's total merchandise trade is $366 billion (ninth place worldwide), export of services $64 billion (50% more than Canada, for example) and investment $28 billion (more than Italy, for example).

EFTA is host to many multinational companies. For example, among the top 500 companies in the world, the market capitalization of EFTA companies is $580 billion, putting EFTA in fourth place after the United States, the EU and Japan.[34]

In terms of competitiveness, the economies of Iceland, Switzerland and Norway rank fourth, eighth and fifteenth in the world, respectively.[35]

As to the content of EFTA's FTAs, they differ according to their date of conclusion and the economic development of the partner country. The older FTAs basically cover trade in goods, without far-reaching provisions in other areas. Today, EFTA aims to conclude second-generation free trade agreements that cover as large a part of their economies as possible. A decreasing part of EFTA's GDP is generated from the industrial sector, but services have become much more important.

Modern FTAs cover goods, services, investments, public procurement, intellectual property and include rules on competition. This better reflects the economic realities of today and is in line with developments in the WTO.

To sum up, some of the main features of EFTA' experiences with FTAs are as follows. Speaking with one voice strengthens EFTA's position. FTAs increase the competitiveness of EFTA companies and promote cross-border investments. Trade volumes have increased an average of 8 per cent with FTA partners versus 2 per cent with non-FTA partners. FTAs promote closer political ties and, in some cases, provide a framework for technical cooperation.

[34] Financial Times, May 2004.

[35] World Competitiveness Yearbook 2005, Institute for Management Development.

It should be emphasized that while EFTA countries pursue a free trade policy, this in no way detracts from their ambitions for a well-functioning multilateral trading system under the WTO. The two approaches are mutually supporting. Developments on one side have a tendency to move things forward on the other. Consensus in the WTO decision-making process tends to ensure a lowest common denominator approach, while the FTAs offer an opportunity for further economic integration for those countries that are willing and able.

4. EFTA and EU enlargement

The enlargement of the EU in 2004 has important trade and economic consequences for many countries, in particular within Europe. EFTA strongly supported the reunification of Europe through enlargement, which they feel will contribute to peace, stability and economic development in the continent. Enlargement created the world's largest internal market, with free movement of goods, services, capital and labour.

To illustrate some of the issues that EFTA was faced with leading up to EU enlargement in 2004, two examples are presented below.

4.1. EFTA-EU trade in marine products

The first example concerns trade in fish between the EFTA countries and Poland. Before Poland's accession to the EU (and consequently the EEA Agreement), there was free trade in fish between EFTA and Poland on the basis of the EFTA-Poland FTA of 1992. During the past 15 years, Poland built up its fish-processing industry, purchasing considerable amounts of raw material from Norway and Iceland. However, EFTA does not have complete free trade in fish with the EU. Therefore, certain fish imports into Poland would be subject to duties under the common EU external tariff after enlargement.

EFTA requested full free trade in fish with the EU after enlargement. EFTA argued, supported by Poland, that without free trade it was entitled to compensation under WTO rules. In addition, EFTA made the political argument that the trade liberalization process of enlargement should not lead to increased barriers to trade. Initially, the EC disagreed. In the end, a

compromise solution was reached, whereby the EFTA side was granted duty-free quotas based on historical trade figures. The downside for EFTA with this solution is that any increase in certain fish exports will be subject to duties. For these products, EFTA will need to develop new markets.

4.2. EFTA financial contributions to the EU-10

The second example is the request by the EU for the EFTA countries to participate in the cost of adjusting the economies of the EU-10 to the standards in the EU. The argument was that EFTA would benefit from increased market opportunities in the EU-10, since they are part of the internal market through the EEA Agreement or, in the case of Switzerland, have preferential access through bilateral agreements.

From the EFTA standpoint, there was a strong willingness to help especially the Eastern European countries to solidify their economic and political position. They were already contributing important sums to this end. The differences of opinion lay with the amount of economic aid and how it should be administered. The argument by the EU that EFTA benefited from preferential access to its enlarged market was not a strong one because (a) EFTA already had FTAs with all the EU-10 except Malta and Cyprus, (b) trade barriers would be raised in some instances (certain fish products) and (c) EFTA's trade with the EU-10 was a very small percentage of their total trade, about 2 per cent.

Some of the main advantages of EU enlargement for EFTA countries were a general decrease in trade barriers for goods through simpler customs procedures, harmonized standards and other benefits deriving from the same economic legislation. In addition, FTAs with the EU-10 did not cover services, which are part of the internal market rules. The EEA Agreement also promotes better investment opportunities and provides for a common labour market. An enlarged EU Internal Market is very much in EFTA's long-term economic interest and brings closer cooperation between the EU and EFTA member countries.

In the period 1999-2003, the EEA-EFTA countries had made binding commitments for financial assistance to the economically weaker economies in

the EEA, a total of €120 million. After enlargement, these contributions increased five fold, to €600 million over the next five-year period, 2004-2009.

Table 2: Overview of the financial support made available by the EEA-EFTA countries to the reduction of economic disparities in the EEA, 1999-2003
Averaged estimates in €million

	1999	*2000*	*2001*	*2002*	*2003*	*Total*
EEA Financial Instrument	24	24	24	24	24	120

Table 3: Overview of the financial support made available by the EEA-EFTA countries to the reduction of economic disparities in the EU, 2004-2009
Averaged estimates in €million (Swiss contributions administered separately in connection with EU bilateral agreements)

	2004-5	*2005-6*	*2006-7*	*2007-8*	*2008-9*	*Total*
Financial support	363	363	363	363	363	1,818
- EEA	120	120	120	120	120	600
- Norway	113	113	113	113	113	567
- Switzerland	130	130	130	130	130	651

The contributions will go to the EU-10 as well as to Greece, Portugal and Spain. The largest recipients are Poland (46.8%), Hungary (10.1%), the Czech Republic (8.1%) and Spain (7.6%). The funds will be made available for projects in areas such as the environment, sustainable development, European cultural heritage, human resources development, health and childcare.

In addition to the EEA-EFTA contributions to the EU, both Norway and Switzerland agreed to give financial assistance to the EU bilaterally for the period 2004-2009. Norway's contribution is made in connection with the EEA Agreement, amounting to €567 million. However, Switzerland's contribution is made in connection with the Swiss-EU bilaterals, €651 million (CHF 1 billion).

The Norwegian bilateral contributions will only go the EU-10. The biggest recipients are Poland (49.0%), Hungary (13.1%) and the Czech Republic (11.0%). In addition to the priorities of the EEA financial mechanism, the Norwegian financial mechanism in particular will focus on implementing the *acquis* regarding the environment and Schengen. Taken together, the EEA and Norwegian contributions represent a 10-fold increase in payments to the EU after enlargement, €1,167 billion.

Adding the Swiss bilateral contributions for EU economic development, the total increase in EFTA payments is a 15-fold increase, to €1,818 billion. However, the Swiss net payments may not change very much because the scheme replaces their direct bilateral assistance to the EU-10.

It should be noted for clarification that EFTA financial contributions to the EU are not the only payments made. Because of the extensive cooperation of the EEA Member countries through the EEA Agreement, the EEA-EFTA countries contribute also to the EU budget to fund cooperation programmes such as in the areas of science and education. The total contributions for the next five-year period are estimated at close to €900 million. However, a large portion of this is returned to the EEA-EFTA countries through grants of various kinds.

The above payments by EFTA to the EU reflect the economic success of the EFTA countries. They are a small but significant contribution towards promoting peace, security and economic development in Europe, and come in addition to many other forms of economic assistance to Eastern European countries, which will not be described in detail here.

5. Challenges ahead

As discussed above, EU enlargement represents a tremendous increase in opportunities for further developing trade relations in Europe. This applies both for the EFTA countries, which have preferential access to the EU market, as well as for other countries in Europe and beyond. Unified trade rules will simplify cross-border trade and decrease administrative costs. The immediate challenge for non-EU countries will be to take advantage of the new opportunities presented. Already many companies are developing their

networks in the EU-10 to be able to participate in the economic benefits that will follow.

The enlarged EU will also create new competitors with the non-EU countries, which must adapt to take on this challenge. They will need to restructure as necessary. They will need to develop new markets outside the EU. A small example was mentioned above in the case of EFTA, i.e. for certain marine products.

An important factor in keeping competitive is for the non-EU countries to develop their own free-trade relations. Especially for the smaller countries, a concerted approach has proven beneficial, for example as in the case of EFTA.

Finally, the increasing trend towards preferential trade agreements presents challenges for the multilateral trading process. Developing the international trade rules of the WTO remains a very important factor for all countries. Experience has shown that free-trade arrangements and the multilateral process are mutually supportive. For example, European integration and the North American Free Trade Agreement (NAFTA) contributed to the successful conclusion of the GATT Uruguay Round. The increase in FTA arrangements worldwide will, one hopes, also fuel progress in the ongoing WTO negotiations. A successful outcome will benefit all, in particular developing and transition economies.

6. Conclusion

EFTA has proven a very successful model for preferential trade for 45 years. EFTA has close links with the EU, through the EEA Agreement and the Swiss bilateral agreements. Because of the close EFTA-EU cooperation, enlargement has significant consequences for the EFTA countries. For the most part, they share a common market for goods, services, capital and labour, the largest market in the world of its kind. Enlargement will bring economic benefits, while the costs include significant financial commitments by EFTA, as well as modest trade restrictions on certain product categories. The challenges ahead will be to develop new trading opportunities with the EU, to look for new markets outside the EU, and to develop the multilateral trading system.

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Chapter 1.3

Financing for Development in the UNECE Region: The Issues Facing South-East Europe

Mr. Leonardo Baroncelli, Deputy Director General, Central European Initiative Executive Secretariat (CEI-ES), Italy

UNECE is making a remarkable contribution to economic cooperation in Europe. In the framework of the CEI-UNECE Memorandum of Understanding, it has offered us its expertise in basic analysis on small and medium-sized enterprise (SME) development, as well as in organizational services both for Central European Initiative (CEI) and joint events.

After the May 2004 enlargement, an EU made up of 25 countries has emerged, with 450 million inhabitants, a GDP amounting to over €10,000 billion and more opportunities for economic prosperity, essential for long-term stability in this continent.

Since its inception in 1989, the CEI has encouraged dialogue and cooperation in the region, well beyond the EU borders, as the more effective means of avoiding the creation of new dividing lines and bringing its non-EU members closer to the European dimension.

To some extent, CEI activities have been anticipated in the European Neighbourhood Policy (ENP) prepared by the EC in Brussels.

After a 15-year experience, the organization is facing a new situation: currently out of 17 member countries, seven are EU members. The centre of gravity of the CEI mission is shifting accordingly and underscores the importance of multiplying efforts primarily in the direction of member

countries that for some years to come need to concentrate on a reform process and upgrade their institutional capacities. This also means that five members that recently joined EU and had been recipients of CEI support shall provide fresh help to the member States still outside the EU borders.

To this purpose, we are promoting new arrangements between the enlarged EU and its neighbouring countries, both parties to CEI.

Furthermore, the Initiative is focusing more on specific, project-oriented activities such as technical cooperation and development programmes aiming at supporting growth and in particular the institutional and economic enhancement of countries in special need. A number of projects and international events, co-sponsored by the CEI through its Funds, are implemented in a variety of fields.

Indeed, the two Funds available to us – the Italian Trust Fund at the European Bank for Reconstruction and Development (EBRD) and the Cooperation Fund – have already demonstrated their usefulness. A recent report on the CEI Trust Fund at the EBRD (€27 million contributed by the Italian Government since 1991) has highlighted a group of priority projects where a CEI grant value of €4 million has facilitated (by technical cooperation) EBRD investments worth €360 million. With regard to its cooperation activities more then 100 projects have been approved since 2002. CEI's total contribution amounted to €1.4 million about 13 per cent of a total cost of cooperation projects amounting to €10 million.

The Project Secretariat and the related Trust Fund are the main instruments for this purpose. The mission of the Project Secretariat is to assist the transformation of strategies and project ideas into bankable projects or fundable programmes. The CEI Trust Fund at the EBRD is available for this purpose. It is used to support technical cooperation linked to investment projects, such as feasibility studies, technical assistance and project supervision. It is also used for promoting a favourable economic and institutional environment in member States, by organizing training programmes, workshops, know-how exchange, advisory services, etc. under the heading of Development Programmes and Cooperation Activities. Another area is the promotion of "project ideas" through matchmaking investors with financial and technical sources, using the CEInet database, paper

documentation (e.g. The Project Guide), and meeting opportunities. All these activities have a main point of convergence in space and time in the annual Summit Economic Forum.

The regional focus is central in our mission. Since economic prosperity is essential for long-term stability in the region, CEI provides assistance and support to the privatization process; it promotes SME development and helps create a business environment conducive to private economic activities and foreign private investment. Programmes and projects are mainly carried out in cooperation with other regional initiatives, international organizations, international financial institutions and, more recently, NGOs.

Activities, regarding growth and competitiveness, concentrate on promoting industrial outsourcing, know-how transfer (tool: Know-how Exchange Programme - KEP), matchmaking of investment project ideas (tool: Networking System) and generally on fostering private sector involvement (tool: Annual CEI Summit Economic Forum (SEF), linked with the Summit Meeting of the Heads of Government and with the Round Table of the Ministers of Economic Sectors).

The SEF is a major opportunity for the whole Central European region to establish business contacts and to offer or request cooperation on projects. In previous years, this top economic event attracted approximately 1,300 participants (industry leaders, senior government officials from the 17 member countries, national/international organizations, financial institutions, other regional initiatives together with businesspersons and senior experts) and addressed issues linked to the European Enlargement and regional cooperation through projects and programmes for institutional and business development in Central and Eastern Europe.

As for trade and enterprise, the creation of a wide pan-European market, based on compatible or harmonized rules and on further trade liberalization will bring considerable economic advantages to CEI-EU and non-EU members.

However, the benefits of the enlargement do not accrue automatically, nor do they apply evenly across countries, sectors and local communities. The

policies of countries themselves will determine their ability to benefit fully from the EU enlargement.

In the new CEI-EU members, the incorporation of the EU standards into the relevant domestic legislation will consolidate the institutional structures and thus will offer better guarantees for enterprises and investors. In the remaining CEI countries, the completion of reforms in order to provide fresh impetus to the market economy and to the privatization process, to business, know-how and manufacturing technique transfer is needed.

Regional financial institutions could accelerate growth and competitiveness by providing technical cooperation support (grants) together with investment operations, credit lines for SMEs with specific facilitation programmes, support trade and outsourcing. A significant contribution from regional financial institutions could concentrate on promoting institution building and a policy dialogue to develop joint solutions with Governments. Looking at the CEI-EBRD experience, regional financial institutions could develop cooperation with regional organizations. This cooperation generally adds a considerable regional dimension to investments by the international financial institutions, widening the "demonstration effect" and know-how transfer potential of projects. Countries in the region (different from the project country location) usually involved as observers in the project development directly benefit from best practices and lessons learned.

Finally, it is necessary to forge a stronger partnership between and among Governments, businesses, regional organizations and civil society in order to take full advantage of the most recent EU enlargement. This is a task that no entity can accomplish alone. For our part we are committed to working closely with multilateral and business partners to share experience through dialogue to enhance the role of the regional approach as a catalyst for growth and development and for a greater and quicker integration of all CEI countries into the changing European economy.

Chapter 1.4

South-East European Cooperation Process

H.E. Mr. Doru Romulus Costea, Ambassador, Head of the Parliament Mission of Romania to the Office of the United Nations and Specialized Agencies in Switzerland

The South-East European Co-operation Process (SEECP), which was created as a non-institutionalized regional cooperation structure in 1996 following a Bulgarian initiative, is a worthy example of how countries of various of international status and different national identities can work together irrespective of their past. Seventy years ago, the Romanian Nicolae Titulescu, whose name is closely linked to the League of Nations, started the Pact of Balkan Agreement – *Pacte d'Entente Balcanique*, so that one can really talk about a certain tradition of cooperation in this region.

The SEECP includes a member of the EU (Greece); two EU acceding countries (Bulgaria and Romania); EU candidate countries (Croatia, the former Yugoslav Republic of Macedonia and Turkey); States parties to the Stabilization and Association Process to the EU (Albania, Bosnia and Herzegovina and Serbia and Montenegro). Moldova is also observer to the Process.

The defining element of the SEECP may be found in its being the only forum in South-East Europe that is created and managed exclusively by the countries of the region. It is based on "regional ownership", as a means to significantly contribute to the improvement of the political climate in an area that has, for years experienced many conflicts.

On the occasion of the European Council in Thessaloniki (June 2003), an EU-Western Balkans Summit was organized, for the first time, with the participation of several countries of our region. Indeed, this proved to be the best way to solve many problems related to security, stability and development in our region. The European partnerships for the Western Balkans, supported by the EC, represent a necessary stage in implementing the Thessaloniki Agenda. It is the strongest motivation to continue the democratic reforms and the social and institutional modernization, in order to achieve increased economic performance.

Romania intends to make use of all mechanisms and instruments promoting the European integration of all SEECP countries, and is ready to offer its own experience regarding the European integration process to countries that wish to accede to the EU. It is important to maintain a vision of integrating all SEECP countries as full EU members and of their major role in stimulating economic development. All these countries are working hard on continuing the reforms needed to provide economic growth and a thorough transformation into a market economy. The Romanian Prime Minister has pointed to the fact that European integration cannot happen overnight; it is a process that requires a whole mix of changes from legal and institutional frameworks, to values and mentalities.

Competitiveness: challenge and opportunity

In this mix, the hardest change to achieve is competitiveness: it's not just a set of rules and regulations, which, in most of our economies, were somewhat rigid and flat. Competitiveness is one of the keys to making the economy sensitive to market demands, able to use technological progress, and ready to take into account financial flows. It helps, as it is conditioned by, political stability and good governance. All these factors are challenges and opportunities that the countries in the region and beyond are aware of.

Regional strategies for reconstruction and development have become self-sustaining, which is proven by various initiatives such as the creation of a regional market for energy and gas, to be integrated into the EU Internal Electricity Market. Romania considers that SEECP could contribute to the concertation of efforts in promoting significant regional projects on

infrastructure modernization – roads, railways, energy, water management and telecommunications.

Cooperation among our countries means, among other things, being able to do away with barriers to regional trade in goods and services, maintaining access to public procurement and regulating State aid and competition policies. This will help in making rapid progress from being a troubled area to being a reliable, business-oriented fast-growing region and credible business partners.

The countries of SEE are relatively low-ranked in most of the reports related to competitiveness. If we take a look at the recent Global Competitiveness Report issued by the World Economic Forum, we will see that, among the 102 countries included in the report, the SEE countries are ranked, with only one exception – Greece, an EU member – far below the second half of the tables referring to Growth and Business Competitiveness. Among the problematic factors for doing business, the most recurrent for our region are tax regulations and tax rates, access to financing, inefficient bureaucracy, corruption, policy instability, but also isolated, yet strongly influencing factors such as inflation, government instability, restrictive labour regulations.

The role of competitiveness for the success both in achieving high economic growth and as a prerequisite in the process of European integration is indisputable. Our countries have solid competitive advantages, having a well-educated workforce and rather low labour costs, which allow for fast economic growth, provided necessary reforms are implemented to tackle the problems of high unemployment and low investment. Prospects seem good for this complex endeavour to be successful. What we all need is consistency and resilience. Many countries in the region are determined to prove they have both.

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Chapter 1.5

Establishment and Further Development of the GUAM Organization

Mr. Oleh Napov, Head of the Division on Trade Policy and Cooperation with International Economic Organizations, Economic Cooperation Department, Ministry of Foreign Affairs, Ukraine

The GUAM group, consisting initially of four countries – Georgia, Ukraine, Azerbaijan and Moldova – was established on 10 October 1997 in Strasbourg in the course of the Council of Europe Summit, during which a Joint Communiqué of the Presidents of Ukraine, Georgia, Azerbaijan and Moldova was adopted. In this document, the "Strasbourg Communiqué", the Presidents stressed the need for developing quadrilateral cooperation to promote stability and strengthen security in Europe on the basis of the principles of respect for sovereignty, territorial integrity, inviolability of State frontiers, democracy, rule of law and respect for human rights. The Communiqué officially strengthened the gradual political rapprochement and deepening of practical cooperation between the countries in many spheres in the international arena, as well as in their bilateral relations.

Later, in accordance with the Washington Declaration, adopted as a result of the meeting of the Presidents of GUAM member countries and Uzbekistan which took place on 24 April 1999 in Washington (within the framework of the summit meeting of the Euro-Atlantic Partnership Council), the format of the forum was transformed to "GUUAM". In May 2005, Uzbekistan officially withdrew from the organization, which then went back to its original name.

Then, on 6 November 2000 in New York, in the course of the fifty-fifth session of the United Nations General Assembly, the Presidents of the GUAM member countries adopted the "New York Memorandum", which envisages

intensifying cooperation within GUAM and rendering it multilevel. Furthermore, the decision was taken to hold regular summits of the heads of States and meetings of the ministers for foreign affairs of GUAM member countries and to establish a coordinating body – the Committee of National Coordinators. The creation of conditions for inter-branch and direct contacts between corresponding State bodies and agencies was agreed on as being the main task of cooperation. Ensuring effective functioning of the Europe-Caucasus-Asia transport corridor and development of its infrastructure was to be accorded top priority.

On 7 June 2001, the first Summit of the GUAM Presidents in Yalta was a crucial event in the formation and institutionalization of this regional organization as an international structure. The "Yalta Charter", signed by the Presidents in the course of the Summit, determined the purposes, principles and directions of cooperation of the Organization[36].

The most essential direction of GUAM's current cooperation is the Project on Trade and Transportation Facilitation, which provides for the establishment of a free trade area among participating countries, to be implemented in strict compliance with the norms and principles of the WTO, as well as the further development of the transport and energy corridors of continental significance, which are situated in the region.

Moreover, today the cooperation among member countries goes beyond bilateral relations, aiming at turning GUAM into an instrument that may secure safety and stability in one of the most unsettled parts of the world. GUAM is able to contribute to world community efforts to combat terrorism and other challenges to security and stability in the immediate proximity of the boundaries of Europe. Signed at the 2003 Summit, the Agreement on the Establishment of the GUAM Virtual Center for Fight against Terrorism, Organized Crime, Drug Trafficking and Other Dangerous Types of Crimes and

[36] Grounds of the organizational structure of GUAM laid down in the Charter have fixed the existing mechanism of cooperation of the participating States. According to the Yalta Charter, GUAM presidency is carried out by the participating States in alphabetical order during a period between the meetings of the Heads of States.

the GUAM Interstate Information Management System present concrete instruments of cooperation in this field.

Implementation of the Free Trade Area

On 20 July 2002, Azerbaijan, Georgia, Moldova and Ukraine signed the Free Trade Agreement, a framework agreement setting out the necessary conditions for the free movement of goods and services among the countries, aiming at promoting economic growth and maintaining sustainable development in the region.

To achieve the goals set out in the Agreement, the participants committed to eliminating all customs duties and taxes in their mutual trade, as well as to removing any quantitative limitations and other obstacles to the free movement of goods and services. At the same time, they undertook to develop an effective system of mutual settlement of accounts and payments.

The Participating Parties also undertook to cooperate in the fields of standardization, metrology and certification with the purpose of removing technical barriers to trade.

They also agreed to take the necessary measures for ensuring maximum simplification and unification of customs formalities, in particular, through establishing common forms of customs and shipping documentation, based on international agreements and arrangements. Moreover, the Agreement foresees further harmonization of customs procedures, as well as mutual recognition of customs documents and guarantees.

The Parties have also agreed not to grant export and other subsidies to enterprises within their territories if the conditions of fair competition are violated as a result of such subsidies. In this regard they undertook to ensure the transparency of the measures related to the granting of subsidies.

All other arrangements forming the scope of the Agreement, such as freedom of transit, re-export of commodities, antidumping and special measures, rules of definition of a country of origin, public procurement, intellectual property protection etc. are in full compliance with the WTO principles and international practice.

As regard services, the Contracting Parties agreed to create conditions for the liberalization of their national markets of services and, on the basis of reciprocity, shall strive for the gradual removal of limitations with a view to the creating conditions for free rendering of services within the free trade area.

Upon the consent of the participants, the Agreement shall be open for accession by any State recognizing the goals and principles of the association and the provisions of the Agreement.

In particular, the expected outcome of the implementation of the Free Trade Area and other projects within the GUAM framework are:

- Creation of more favourable conditions for the steady development of trade in the region;
- Wider and active introduction of internationally accepted trade policy principles and instruments based on their complete conformity to WTO rules and norms;
- Using advantages, benefits and new opportunities from EU enlargement, as well as minimizing of possible negative economic consequences from expected increased competition throughout the European region after enlargement;
- Reliable, stable and safe functioning of transport corridors running through the region, in particular, ensuring alternative delivery of crude oil to Europe.

We consider our joint efforts to be part of a comprehensive involvement with the European Economic Area and the developing transcontinental transportation network.

The average trade turnover among the four countries participating in the Agreement is currently around $1 billion.

Among the next priority actions for developing the legal basis for the GUAM Free Trade Area are the following:

- Agreement on the creation of a working body ensuring coordination of action by the State participants for maintenance of performance of the Agreement provisions;
- Protocol on rules of origin;
- Agreement on the re-export of goods and issuing of re-export permissions;
- Agreement on the order of granting of the information regarding the existing taxes and other dues and fees of a fiscal nature;
- Agreement on creation of conditions for liberalization of the markets for services;
- Agreement on the order of customs registration and customs controls;
- Agreement on import licensing;
- Agreement on rules of procedure for dispute settlements;
- Agreement on application of technical, medical, pharmaceutical, sanitary, phytosanitary and veterinary norms, rules and requirements as to the goods imported into the markets of the GUAM countries;
- Agreement on cooperation for the protection of the consumers' rights;
- Agreement on cooperation in the field of labour migration and social protection of migrant workers;
- Agreement on cooperation on intellectual property rights protection;
- Agreement on development of industrial cooperation.

Any technical and expert assistance in this regard from the United Nations and the EU institutions would be welcome.

In conclusion, Ukraine regards participation in GUAM as an important element in maintaining the sustainable development in the region.

Annex 1
International legal instruments adopted within the framework of GUAM

- Yalta Charter of GUAM
- Convention of GUAM member States on Rendering Mutual Assistance in Consular Issues
- Regulations on the Council of Ministers for Foreign Affairs of GUAM Countries
- Agreement on Creation of Free Trade Area
- Temporary Regulations relating to the Information Office of GUAM in Kyiv
- Decision of the Heads of GUAM member States concerning the Status of Observers of GUAM Activities
- Agreement on Cooperation between the Governments of GUAM member States in the Sphere of Struggle against Terrorism, Organized Crime and other Dangerous Kinds of Crimes
- Instruments relating to cooperation in separate spheres

Annex 2
Organizational structure of GUAM

The organizational structure of GUAM is currently composed of:

- The supreme body, which is the annual meeting of the Presidents of GUAM member States;
- The executive body, which is the Council of Ministers for Foreign Affairs of GUAM member States;
- The working body – in the form of the Committee of National Coordinators of GUAM consisting of coordinators, one from each member State;
- The Information Office in Kyiv;
- Coordination of cooperation between GUAM member States at the branch level is laid upon eight Working Groups, that is, for power engineering; transport; trade and economics; information science and telecommunications; culture; science and education; tourism; the struggle against terrorism, organized crime and the dissemination of drugs.



Integrating Regional Markets: Trade Facilitation and ICT

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Chapter 2.1

Eastern European Digital Modernization

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This paper reviews the developments in the ICT markets in Estonia, Hungary, Lithuania, Latvia, Poland, Slovakia, Slovenia, and the Czech Republic (hereinafter CEEC-8) before they became members of the EU.[37] This analysis offers valuable insights for candidate countries. Special attention is devoted to the problem of digital modernization, this being considered the most important prerequisite for the process of technological and economic convergence.

Former market separations for fixed and mobile voice transmission, TV and radio broadcasting are blurred by digitization, resulting in the emergence of more competitive, larger markets. This convergence has major implications in economic and regulatory perspectives. The fact that the United Kingdom already set up an integrated regulatory agency in 2003 testifies to the new regulatory landscape in the digital sector – broadly defined – in Europe.

The CEEC-8 started at the beginning of the 1990s a process of fundamental political and economic transformation, aiming at a functioning market economy and the development of a competitive industrial sector.[38] For about a decade, the economic policy of these countries has been dominated by efforts to solve transformation problems in the fields of social, economic or labour market policy, this being a natural consequence of the process of transition

[37] In May 2004 all CEEC-8 countries joined the EU.

[38] In addition, the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities was also a priority at the time.

from the old centrally planned economy to a new decentralized system (Kolodko, 2002). Telecommunications had not been a priority for reform. Certainly, competition policy was part of a systemic transformation and the regulatory policy of infrastructure sectors, but no special emphasis being placed on the telecommunications sector.

For many years the economic potential of both the telecommunications sector and ICT was not properly appreciated. Short-term budgetary revenue aspects of telecommunications services – offered by a national monopoly operator – were often considered more important than long-term aspects of digital modernization, the telecommunications sector and the associated spillover effects. In the socialist period, CEEC telecommunications could be characterized as backward and poorly performing[39] and as being a source of a tremendous "digital divide" in basic communications infrastructure at the European level.[40] The situation has changed since 1989/1990, although there is still a large modernization gap, with the EU-10 far away from EU standards.[41]

Considering the social and economic advantages associated with well-performing telecommunications systems in developed countries, CEEC-8 certainly found in the run-up to EU membership that modernization opportunities were neglected in the early 1990s when policymakers showed

[39] Within CEEC-8 in 1989, telephone penetration rates were even below 2 per cent in rural areas and below 8 per cent in cities, main lines digitalization rates 6 per cent, number of main lines not connected to automatic exchanges up to 10 per cent, telephone faults up to 60 per 100 users per year. (ITU, 2002)

[40] The underdeveloped telecommunications infrastructure has achieved a political dimension in April 1997, when access to telecommunications had been considered a basic human right. In 1997, the United Nations issued a statement on Universal Access to Basic Communication and Information Services.

[41] To avoid any misunderstanding, it should be mentioned that here the term EU standards does not refer to the technological aspects of modernization, as is normally common. Here it refers to the preferences according to ICT consumption. It is important to know that these slightly differentiate themselves in Central and Eastern Europe from EU developments.

limited interest in upgrading and restructuring the telecommunications sector.[42] The countries that joined the EU in the 1990s, and that were at the time less advanced – including Finland and Ireland – received a boost to economic development from the modernization of telecommunications: the stimulation of broader ICT sectors can have positive long-term effects on productivity growth and output dynamics. This clearly points to potential for digital catching-up in Eastern Europe.

For Central and Eastern European countries, the problem of digital modernization is especially important because of the following aspects:

Integration process: Assuming that the economic significance of information and communications technologies in EU countries increases exponentially, the underdeveloped ICT environment in CEECs can lead to a sustained digital divide within the Community. From a medium-term perspective, such a divide would become an obstacle in the process of European integration; in a single EU-25 market, countries having relatively poor telecommunications and Internet infrastructure will face high communication costs – and transaction costs, in particular for international trade – which are similar to a tariff on trade. Moreover, FDI inflows would be rather low as multinationals need a modern telecommunications network to optimally organize production abroad; as roughly one third of international trade is intra-company trade (within multinational firms), countries attracting only small FDI inflows on a per capita basis will also suffer from non-realized trading opportunities.

Process of economic catching-up: ICT brings new opportunities to accelerate the process of catching-up. Governments as well as the business community in CEEC-8 should understand the opportunities of ICT and provide adequate ICT investments as well as incentives to attract ICT producers. ICT products will certainly be imported to a large extent in CEEC-8; however, taking a look at Ireland – a major producer of ICT in the 1980s and the 1990s among members of the OECD – it is obvious that small, less advanced

[42] It has to be taken in consideration that the systemic transformation process embodies a very high level of complexity and sometimes gives policymakers little room for promoting the most convenient and optimal strategy for modernization of old structured economies.

countries under certain circumstances can attract high technology multinationals in the ICT sector. Given the fact that wages in Eastern Europe are much lower than in EU-15 and that there is a broad base of skilled labour in several Eastern European countries, it could be possible to attract major ICT producers. Hungary successfully attracted IBM as a producer and exporter of hard disks in the 1990s. Yet in the course of dynamic product cycle, IBM closed its Hungarian factory in 2002 and relocated production. Poland and Estonia have begun to actively try to attract foreign ICT producers.

1. Digital modernization

"Digital modernization" is basically understood here as the process through which historically developed sectors and institutions in the field of computation, communication and data storage switch to digitally oriented technologies and procedures; in particular, switching from analogue transmission of voice and pictures to digital transmission is crucial. Digitization allows a wide array of innovative recombination of digitally stored information and knowledge as well as the use of both in computer-controlled production or service provision. Digital modernization reflects a broad dynamic increase in knowledge and allows for the development and management of novel complex systems. Broader modernization waves have typically been accompanied by a scientific revolution.[43]

Narrowly defined, digitization can be understood as the process of conversion of a system from analogue to digital. The process of digitalization specifically concerns technological aspects and makes it possible to generate, process and transmit any type of information (voice, data, video) in a binary system of zeros and ones. This technological revolution has broad implications, especially in tree dimensions (e.g. quality, speed and capacity).

With respect to ICT, digitization has to be defined broadly. On the one hand, it concerns the process of digitization of existing communication networks, access infrastructure, products and services; on the other hand, it stands for an element of a changing market structure since digitization

[43] This definition has been formulated based on the definition of modernization presented by C.E. Black in "Dynamics of Modernization" (1996).

implicitly merges formerly separated markets such as voice telephony, cable TV and mobile telephony. Hence it goes along with an implicit opening up of markets and a merging of markets. Digital modernization is thus pro-competitive.

Digitization also raises doubts about whether telecommunications is a natural monopoly. Taking into account the survival of several mobile operators in several EU countries, the mobile telephony business certainly is not a natural monopoly (the standard assumption of traditional telephony). The issue of natural monopoly is more complex when it comes to fixed line telephony where high sunk costs imply that markets are only weakly contestable; actual and potential competition are rather weak unless one could duplicate – at similar costs – nationwide networks on the basis of mobile communication technology. The more users consider mobile telephony a substitute for fixed line telephony, the more obsolete the natural monopoly argument in telephony. Whether mobile telephony and fixed line telephony are complementary or substitutive is an empirical question. For certain younger strata of the population, mobile telephony might well be a substitute for fixed line telephony. However, this certainly does not hold true for the majority of telephone users.

Digitization allows for a much more flexible and efficient management of spectrum than previous technologies; as spectrum is a scarce input in communication digitization, this amounts to factor-augmenting technological progress. From a technical point of view, digitization makes systems rather open. Any new network operator interested in linking up with the public network will find the existence of digital transmission much easier than reliance on the old analogue system. Digitization opens up a wide range of business opportunities especially for areas with a high rate of return. Digitization of communication systems influences the cost functions of firms. It reduces the marginal costs of communication services and thereby brings efficiency gains at the firm level, but this also uses transaction costs, which, in turn, implies trade creation.

Digital modernization should also be seen as a dynamic competitive process. As such, modernization is a key element for major suppliers; all competitors are stimulated to upgrade existing technologies. Many companies enrich their business activities, and in addition to the core business, firms

intensify research and development. Thus companies contribute more actively to the national innovation system, thereby enhancing the competitiveness of the whole economy.

Digital modernization boosts the creation of new markets, thus creating perspectives for new business opportunities in many companies. This observation refers to both the ICT sector, expanding through an increasing demand for use of advanced information and communication technologies, and to firms in the old economy. It also refers to the products and services which can be digitalized and traded electronically. Without digitization, the creation of new communications systems and platforms such as fast Internet, high definition television, advanced satellite TV and satellite and mobile telephony would not be possible. Digitization reinforces the role of information as a production factor; growing dependence on information in production processes partly reflects the dynamics of a new economy and of a new economic sector, the information sector (Porata, 1974, 1976; Dziuba, 2002).

The process of convergence is stimulated by digital modernization. Digitization eliminates existing borders between various kinds of information – voice, video, data. The dynamics of markets and technologies will lead to a multilayer process of convergence in networks as well as in services. Digitization will also stimulate interactivity in many fields, and this is relevant for the business sector and private households, and Governments as well.

Digital modernization stimulates internationalization of the economy. Generally speaking, the process of digitization is effectively melting various information and communications platforms or making them easier to interoperate. Through digital modernization, the EU-10 will get broad access to a borderless cyberspace that is relevant in nearly all sectors. However, as regards carrier services, there are EU rules which have to be implemented in member countries. The fact that digitization creates new and larger international markets plays a crucial role especially for the small economies where the home market is rather small and where economic growth can be strongly stimulated through international cooperation or trade-promoting activities.

As communication is a reciprocal act and since some network externalities in some ICT fields are international, EU-15 countries will gain from the digital

modernization of the EU-10. Increasing use of ICT will stimulate trade within the enlarged EU. Digital modernization will finally stimulate diversification in ICT production and in digital services, whereby countries will try to exploit digital comparative advantages. Countries which are richly endowed with information and information capital – plus complementary human capital – will specialize in information intensive goods in production and exports. This is a natural development in a dynamic international division of labour.

Digitization enhances democratic procedures and can stimulate efficiency gains in the public sector. The effects of digitization are twofold:

- Digitization of information systems of the public sector can raise efficiency. New digital services can be introduced, many traditional services automated, and all services will become more reliable. As CEEC-8 has to modernize public administration, this creates many opportunities for welfare gains and productivity increases; and
- The speed of information flows within public administration and democratic institutions will be enhanced, and thus the efficiency and transparency of governing bodies increased. As digital modernization reduces the marginal costs of public services, there could be cost-cutting effects and thus a welcome incentive for the provision of public services in a situation in which budgetary consolidation ranks high for all the EU-25 in the context of the Stability and Growth Pact (with limitations for the debt-GDP ratio and the deficit-GDP ratio). More transparency might also help to reduce corruption significantly, bringing an increase in the credibility of public institutions

Essentially, digitization will help to meet the Copenhagen criteria in several ways. EU-10 countries could find it easier to withstand the competitive pressure in the EU Single Market and improve the efficiency of public institutions, in turn resulting in higher investment, growth, employment and tax revenues.

2. Costs of digital modernization of access infrastructure

For decades, the communication infrastructure in Central and Eastern European countries has been underdeveloped compared with other European countries with similar per capita income. In the socialist system, the

Communist Party considered communication systems politically sensitive and put a clear priority on communication among firms; individual telecommunications was neglected to a large degree, leading to low telecom density. The political change in 1989/1990 altered the political paradigms. Diversified preferences of both households and the business sector became accepted, the telecommunications monopoly was restructured, and in some countries partial privatization began. Modernization measures in the public switched telephone network (PSTN) are especially worth noting, especially in terms of digital modernization. The experience of the most advanced countries at a global level shows how digitization crucially upgrades the quality of the core communication infrastructure, opening up new areas for digital communications. Integrated services digital networks (ISDN) and xDSL (generic digital subscriber line) have been introduced as interim technologies to bolster existing network performance within acceptable cost parameters.[44]

Poor and analogue fixed infrastructure has forced the EU-10 to intensify investment in the telecommunications sector, where two aspects were emphasized:

- The telecommunications network and service accessibility had to be extended relatively quickly, and the quality standards had to be simultaneously improved;
- Subscriber lines and trunk networks had to be modernized; such modernization is considered a prerequisite for the provision of new digital communication services (e.g. broadband data transmission).

Taking the penetration rates of fixed telephony in 1991 as the point of reference, and an EU average penetration rate in 2002 of 54 per 100 inhabitants (IBM, 2003) for an interim desirable optimum in the EU-10, the required capital for digital modernization and the extension of a fixed telephone network for each country can roughly be estimated as shown in table 1. To achieve the average EU level of fixed telephone penetration, the

[44] ISDN is increasingly being deployed in fixed line telephony networks, which have found their market niches in the high-speed Internet access and SOHO (small office-home office) markets. xDSL provides a temporary fix by using the existing copper drop plant to support broadband applications; it gives the telephone companies the ability to compete with the cable-TV operators' coaxial drop bandwidth advantage.

EU-10 should install 30.5 million telephone lines and bear the additional costs for the digital modernization of existing networks. Supposing that the costs of new telephone connections (digitally compatible) amount on average to $1,000,[45] the mere extension of fixed telephony networks would require investment exceeding $30 billion in the region.

In addition, the costs of modernization of old fixed line infrastructure have to be considered. According to Welfens and Graack (1997), the incremental costs of upgrading existing networks to standards allowing basic digital communication, e.g. Integrated Services Digital Network (ISDN), range from 20 per cent to 30 per cent of total investment. Thus for all of CEEC-8, the capital needed for upgrading existing networks would range from $1.9 to $2.9 billion. Such upgrading investment could be financed through retained earnings and bank loans. Increasing investment in order to achieve higher penetration rates in fixed line telephony will require raising new equity capital in stock markets; tight governmental budget deficits make it very difficult to augment the capital base of the dominant operator by injecting new government funds.

By the end of 2002, telephone penetration had not achieved the EU level. Given the enormous technological progress in mobile telephony and falling prices of the respective equipment, mobile telephony is relatively important in overall telephony within the EU-10; in addition, there is cable TV in urban areas, as well as other options which seem to have become a substitute for fixed line investment.

Through the end of 2001, about 15.8 million new fixed telecommunications connections had been installed in the EU-10, which should be equivalent – based on the assumption made – to an overall investment of about $16 billion (see table 1). The average penetration density of fixed telephone access has risen from a level of 22.5 to 40.1 telephones per 100 inhabitants. The highest growth rate in accession lines has been achieved

[45] The average costs of new fixed telephone lines vary in the literature depending on density, geography, and broadband, e.g $250 and $1,000 by Navas-Sabater et al. (2002), $1,000 and €2,500 by Welfens and Graack (1997), and $1,800 and $2,500 by Raghbendra and Majumdar (1999).

in. the Czech Republic,[46] Hungary, and Poland. These countries' net growth in fixed telephone accessibility ranged from 20 per cent to 26 per cent over a decade. This development implies that there is true digital bridging in the newly enlarging Community, not in the least since those countries were among the socialist countries with relatively low density figures in the 1980s. At the beginning of the 1990s, the penetration rate was one of the lowest among CEECs and was under 20 per cent (also in Slovakia).

In summary, one can observe that the combined costs of digital modernization investment in telecommunications (roll out of infrastructure and upgrade of existing networks allowing for digital communication) amounted to nearly $19 billion for the EU-10, equivalent to about 2.6 per cent of accumulated gross fixed capital formation in the decade from 1991 to 2001.

The process of digitization of fixed telecommunication infrastructure has not been finished in Eastern Europe. Only four of the EU-10 had achieved full digitalization of fixed networks in 2003. All others are still modernizing their infrastructure. Medium-term achievements are rather satisfactory and in most cases have brought a digitization degree of about 80 per cent (figure 1).

Despite more than ten years of modernization of the telecommunication sector, Eastern European telecommunications companies are still relatively inefficient and achieve weak ratings in productivity in international comparisons. The aggregate telecommunications revenue per employee is below the EU average ($237,834) and for some countries (e.g. Poland or Slovakia), the difference is twice as large, $100,513 and $64,274 respectively (OECD, 2003).[47]

[46] It should be mentioned that data concerning the Czech and Slovak Republics for 1991 represent their respective geographical regions of the former Czechoslovakia.

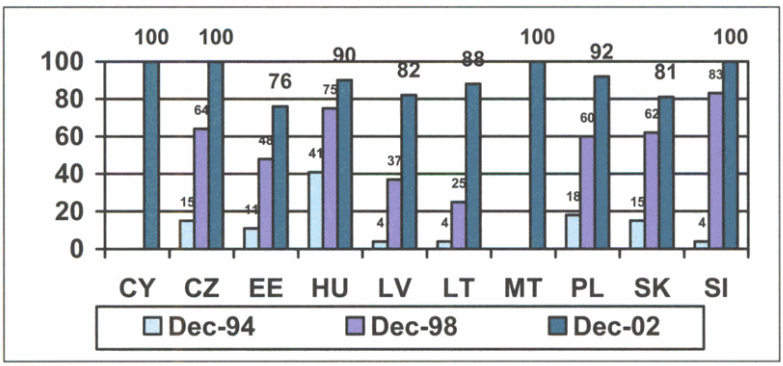
[47] On the other hand, it should be observed that CEECs have experienced rapid growth in productivity in communication sector over the last several years, e.g. the revenue of each employee in both the Czech Republic and Hungary has increased by 20 per cent (in Poland, 10%) in the decade up to 2001 (OECD, 2003).

Table 1: Rough Estimated Costs of Digital Modernization in EU-10

	Fixed Telephone Penetration (percentage)			Number of fixed connections	Number of new fixed connections	Costs of roll out of fixed infrastructure 1991-2001	Costs of digital modernization of existing networks Incremental costs: 20% - 30%
	1991	*2001*	*Net Change*	*1991*	*1991-2001*	*$ million*	*$million*
Cyprus	44.59	63.40	18.81	337,546	142,392	142,4	67,5 – 101,3
Czech Republic	16,57	37.50	20.93	1,702,236	2,150,139	2,150,1	340,4 – 510,7
Estonia	21.19	37.70	16.51	290,091	226,022	226,0	58,0 – 87,0
Hungary	10.89	36.80	25.91	1,091,396	2,596,700	2,596,7	218,3 – 327,4
Latvia	24.39	32.10	7.71	578,531	182,881	182,9	115,7 – 173,6
Lithuania	22.00	33.70	11.70	812,900	432,315	432,3	162,6 – 243,9
Malta	38.60	53.40	14.80	150,540	57,720	57,7	30,1 – 45,2
Poland	9.32	31.60	22.28	3,602,180	8,611,220	8,611,2	720,4 – 1.080,7
Slovakia	14.39	32.40	18.01	777,319	972,864	972,9	155,4 – 233,2
Slovenia	22.91	42.40	19.49	455,451	387,461	387,5	91,0 – 136,6
Together	**22.5**	**40.1**	**17.6**	**9,798,190**	**15,759,714**	**15,759,7**	**1,959,6 – 2,939,5**

Note: The figures should be taken as a rough estimate only.
Source: ITU (2002), own calculations.

Figure 1: Digitalization rate of fixed networks in CEECs (percentage)

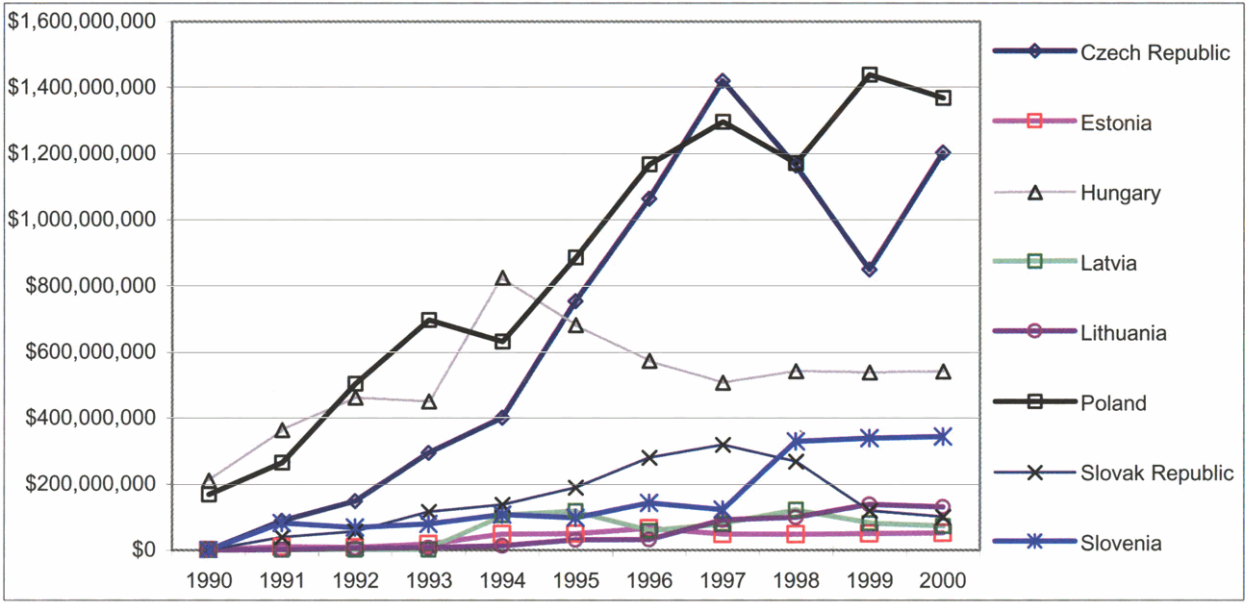


Source: IBM (2003) and ITU (2002).

Moreover, considering the basic financial indicators of the incumbent operator in 2002 – having a dominant role in the fixed telecommunications market – one can observe that the profit rate in Eastern European countries before interest and taxes relative to total capital employed (ROCE) minus the inflation rate in most of the EU-10 did not exceed 10 per cent (only Hungary's ROCE achieved a level of 17%, with inflation at 5%). This has broad implications in terms of foreign investment.

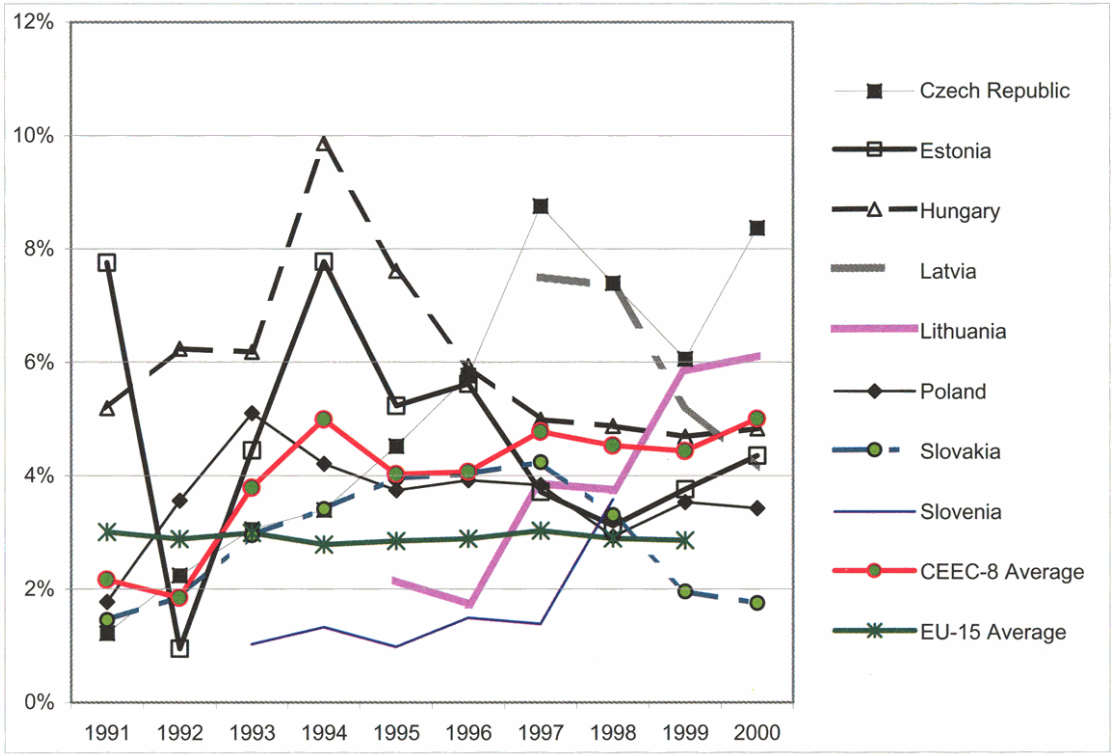
Since 1993, the average annual share of telecommunications investment in gross fixed capital formation of the EU-8 has exceeded the EU-15 average, which can be taken as an indicator of real catching up in infrastructure (see figure 3). A similar situation can be found in Spain, Portugal and Greece, whose key indicators were also behind that of the EU average. However, all countries benefit from extra revenue in telecommunications generated by tourists. Among the EU-10, these effects are much lower, except for Hungary, the Czech Republic and Estonia. It is clear that both population figures and the size of the economy are crucial for the absolute level of investment in telecommunications; by this token, Poland should clearly take the lead, followed by Hungary. However, after 1995, position No. 2 was taken by the Czech Republic. Slovenia's investment increased strongly after 1997 (figure 2).

Figure. 2: Annual telecommunications investment in the EU-10



Source: ITU (2002)

Figure 3: Share of telecommunications investment on gross fixed capital formation



Source: ITU (2002)

If one considers telecommunications investment relative to overall gross fixed capital formation, we can see in figure 3 that the CEEC-8 group had a higher share than EU-15 after the transformation recession of 1991 to 1993. In the early 1990s, Hungary and Estonia were clear leaders among transition countries; in the late 1990s, several countries recorded relatively high investment shares in telecommunications, namely the Czech Republic, Lithuania, Latvia and Hungary.

3. Financing digital modernization in Eastern Europe

Few countries have emphasized investment financing from revenues originating from the national operator directly (including privatization revenues); Hungary is a case for the latter to some extent, but the main source of investment financing was bank lending and new equity as well as profits. Poland has tried to use revenues from selling licences in fixed line telephony for financing increased investment in fixed line telephony. In 2003, a new bill was passed creating the possibility that licence revenues be used for investment in telecommunications infrastructure. In 2003, some $350 million had been paid by the three fixed telecom operators[48] for their respective licences (allowing entrance into the market of long distance telecommunications services). From an economic policy perspective, this approach gives the Government a new instrument encouraging the development of the telecommunication infrastructure. One may assume that such an approach could be especially important for countries in which the communication infrastructure still needs to be upgraded on a large scale.

As regards the required capital for digital modernization programmes, the question of sequencing in the process of transformation of the telecommunications market from a monopoly to a competitive system is significant. It could be argued that the opportunity for keeping a legal monopoly for some time allows the monopoly operator to exploit part of the consumer surplus and obtain a higher profit. These profits could be used for accelerating digital modernization and an extension of the core communication infrastructure. Such a perspective is, however, doubtful since it must additionally assume that maintaining the monopoly position is associated with effective restructuring of the dominant operator. If introducing competition

[48] Telefonia Dialog, Netia and Elektrim.

goes along with product innovation and hence higher profits for some new services – while the monopoly rent is gradually melting away – under competition, overall profits in the telecommunications sector need not be lower than in the monopoly case. As switching to competition brings a higher output and a higher innovation rate in the telecommunications market than the monopoly case, few arguments can be stated in favour of transitorily maintaining a telecommunications monopoly and State ownership. "Corporatization", or transforming a government-owned company into a company listed on the stock market (with minority private ownership in the beginning), is a minimum requirement for major efficiency gains. Firms listed in the stock market will have to publish a wide range of financial and performance data, and this transparency is already a welcome ingredient for medium-term restructuring and privatization. Full privatization will normally improve corporate governance and stimulate static and dynamic efficiency gains; however, the rating of a private company is often weaker than the rating for government bonds, leading to rising costs of capital accompanied by privatization. For the dominant operator, the provision of universal services – for which government fixes a price often much above its costs – could help to generate safe medium-term profits; this aspect is quite important when it comes to full privatization.

The scarcity of national financial resources has forced telecom enterprises in CEEC to use international capital inflows for investment financing and restructuring. Given pent-up demand at the end of the socialist period and a positive income elasticity of the demand for telecommunications (and sustained growth expected from the transition to a market economy), considerable investment opportunities exist in telecommunications. With the rather limited domestic savings in low-income economies of Eastern Europe, there clearly is a welcome role of strategic investors as well as of international finance institutions (e.g. EBRD, EIB, The World Bank).

Telecommunications financing activities of major international institutions are typically a signal for private international investors to also invest in the respective country and sector. This, however, does not rule out that cyclical ups-and-downs of the EU-15 telecommunications sector affect the ability of telecommunications firms in Eastern Europe to obtain financial resources for telecommunications projects. FDI outflows from EU-15 to CEEC-8 typically fall in periods of recession among the EU-15 when profits are relatively small. It is obvious that the collapse of the stock market bubble in New York in 2001, when telecommunications stocks fell over-proportionately, has negatively

affected stock markets and the perception of analysts in Western Europe. The new scepticism has also made the financing of telecommunications in Eastern European countries relatively difficult, even if local market analysis suggests an enormous potential for medium-term expansion.

The financial engagement of international institutions in the process of digital modernization in the EU-10 countries should not be overlooked. EBRD is of particular relevance. Between 1990 and 1999, EBRD was engaged in 50 telecommunications, informatics and media (TIM) projects (total project costs of €7.3 billion) in 20 transition economies with capital totalling €1.3 billion.

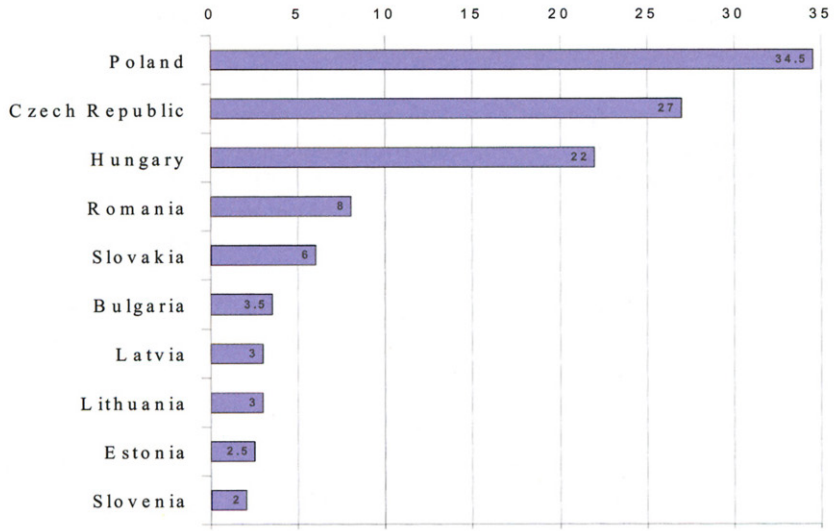
The annual total of EBRD financing commitments to TIM projects has ranged from €100 million to €200 million. Although only 41 per cent of the projects in the "EBRD pipeline" that were intended for Central Europe and the Baltic States were brought to fruition in 2001, one may assume that this source of investment financing could become less relevant in the medium-term in the EU-10. This should hold true because EU membership will strengthen the role of banks and capital markets in the EU-10.

At the same time, the role of EBRD in the further process of digital modernization should not be underestimated. EBRD has a wide range of instruments to support project financing, such as becoming active in loan syndication, and providing guarantees for longer maturities or partial guarantees. This could be crucial in encouraging private financing of the ICT infrastructure in transformation economies.

Moreover, funding in the framework of the existing EBRD Technical Cooperation Fund Program in CEECs and the Baltic States should not be overlooked.

Between 1990 and 1999, €2.1 billion was granted. This type of financial help is quite valuable. Additionally, the EU-10 and the EBRD have signed a Memorandum of Understanding, which should promote the development of the telecommunications sector in Central and Eastern Europe and EECCA.

Figure 4: Cumulative FDI Inflows 1989-2001 ($ Billion)



Source: WIIW – WIFO (2002)

The function of other international finance institutions, such as the European Investment Bank (EIB) should also not be underestimated in the impact on the process of digital modernization (EBRD, 2000). Since 1990, EIB's financial engagement in the form of loans for infrastructure development projects reached €15.8 billion.[49] Seventeen per cent of this amount, i.e. $2.7 billion, was given as loans for the digital modernization of communication infrastructure in CEEC-8, covering investment programmes in fixed, mobile and data transmission networks.

Foreign direct investment has also played an important role. However, there is at least one caveat. Although the privatization revenues are also regarded as foreign direct investment, it does not directly contribute to the process of digital modernization to the extent that government, as the owner of the national monopoly operator, uses privatization processes to cover general government

[49] This means that within period of 14 years (i.e., 1990-2003), EIB gave CEEC-8 loans for various investment programs in the amount of $15.8 billion, including ICT.

expenditures; in other words, privatization revenues in the telecommunications sector have often been used outside the telecommunications sector. Nevertheless, there is a clear positive role for strategic foreign investors. Overall, inward foreign direct investment in the EU-8 in the period from 1989 to 2001 amounted to more than $100 billion (see figure 4). Although more than 60 per cent of this amount was absorbed by three countries (i.e. Czech Republic, Hungary and Poland), it must be mentioned that in terms of FDI per capita (concerning average FDI per capita in the decade 1991-2000), other countries are the leaders in the EU-10, namely Slovenia, Slovakia, Lithuania and Malta.

Because of data problems, it is very difficult to assess the meaning of FDI for the telecommunications sector. Basic figures are: (a) the share of transportation, storage and communications in FDI were 10.7 per cent in Poland, 11.9 per cent in Czech Republic to 13.9 per cent in Slovakia; (b) the share of FDI in postal services and communications in Slovenia amounted to 4.2 per cent of overall FDI inflows; and (c) the FDI share of transport and communication in Lithuania, Estonia and Latvia amounted to 14.7 per cent, 22.0 per cent to 24.0 per cent respectively (WIIW–WIFO, 2002).

In a long-term perspective, foreign investment in the manufacturing industry in Eastern European countries has grown significantly. The ICT sector has become more and more important for foreign investors, whereby the telecommunications sector is crucial. Producing telecommunications equipment also became important in some CEE countries in the late 1990s. Assembling lines in the electronics industry can be built quickly if conditions for investors are attractive in Eastern Europe.

With respect to digital modernization in the EU-10, the role of the International Telecommunication Union's international settlement regime is noteworthy. Generally speaking, CEECs represent the beneficiaries of this international organization and the respective settlement rules. The price-oriented split of revenues in international telecommunications – between the outgoing country/operator and the incoming country/operator – has benefited countries with high prices of monopoly operators (or of operators which have politically set prices at a rather high level). Because the prices for international services in CEECs have been kept at a high level, a strong asymmetry in traffic between developed and CEECs has emerged. Western telecommunications operators have been obliged to effectively give a generous contribution to CEECs' incumbent operators. We can easily highlight the asymmetry in

international calls between USA and CEEC between 1990 and 1999. CEECs received about $1.6 billion that decade (Wallsten, 1998); Poland, which is among the ten biggest net settlement surplus countries (seventh position, 1998), received about $145 million net in 1998 from United States telecom operators (Kelly and Woodall, 1999, p. 3).

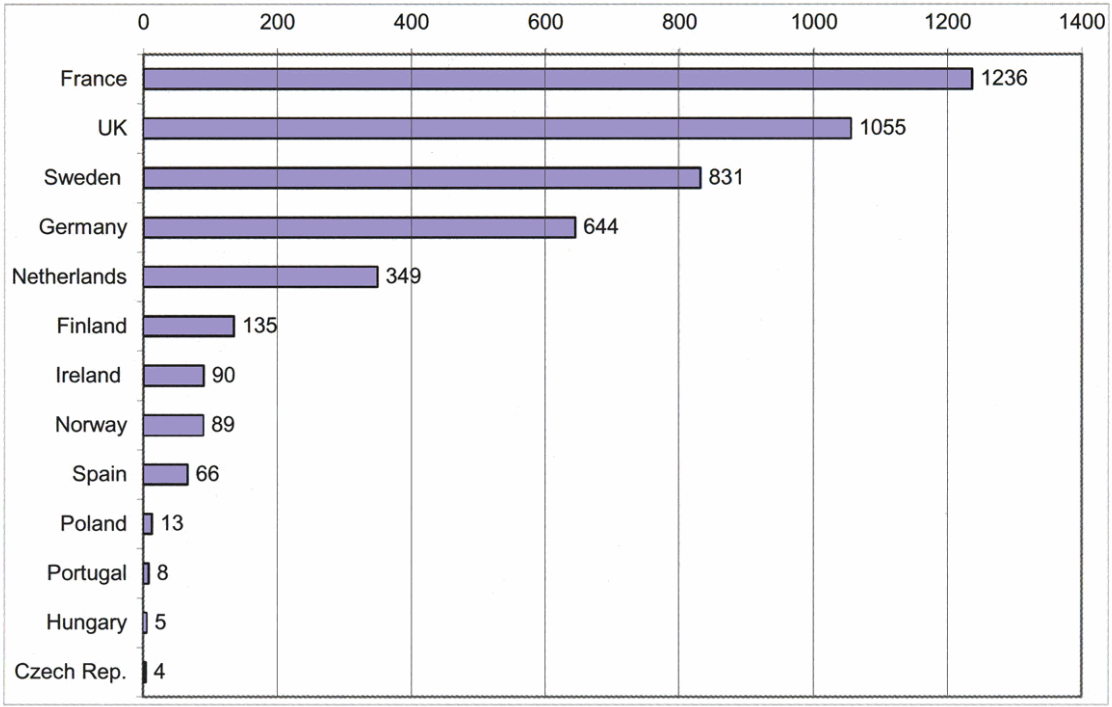
New financing instruments such as private equity investment played a marginal role in the process of modernization in EU countries, with the exception of Germany, France, Sweden and the United Kingdom. In general, private equity investment in European high-technology companies[50] decreased in Europe in 2001 and 2002, after a fast increase from €2.3 billion in 1997 to €11.5 billion in 2000.[51] In 2002, this reached a level of €5.3 billion (PWC, 2003). Similar trends can also be observed in the four biggest CEEC, with private equity investment in high technology sectors reaching not more than 0.1 per cent of the total amount invested in Europe in the Czech Republic, Hungary and Slovakia and 0.2 per cent in Poland.[52] The share of private equity invested in technology-intensive fields does not exceed 0.3 per cent of European private equity investment in some of the less technologically advanced EU countries. By contrast, private equity investment has played an important role as a financing instrument on the technology market in France (23.4%), the United Kingdom (19.9%), Sweden (15.7%) and Germany (12.2%). Taking a closer look at venture capital investment in Europe (being part of private equity investment), we see that Poland, Hungary and the Czech Republic rank low in international comparison (see figure 5).

[50] A wide range of sectors are understood under the term, technology: communications, computer-related, electronic-related, biotechnology, medical/health related and Internet technology.

[51] EU-15 plus Norway, Switzerland, the Czech Republic, Hungary, Poland and Slovakia.

[52] Private equity technology investment in the Czech Republic, Hungary, Slovakia and Poland achieved the levels of €4, €5, €1 and €13 million, respectively.

Figure 5: Venture capital investment in high technology in Europe, 2002 (in $ million)



Source: PWC (2002)

The digital modernization of telecommunications also has implications for the trade balance. Upgrading and extending the communications network requires increased imports of technology-intensive equipment and software.

Thus, it is interesting to examine trade patterns of telecommunications equipment.[53] Generally speaking, the digital modernization has significantly contributed to a rising trade balance deficit in CEE countries (see figure 8). There was a gradual increase in the import of telecommunications equipment in the first half of the 1990s and an acceleration in the second part of the decade (see figure 7).

The increase in exports of such equipment from Central and Eastern European countries (see figure 6) is also noteworthy, although the amounts and annual growth rates do not exceed the figures on the import side except in Hungary and Estonia, which both had large multinational company investment in the electronics industry. Positive growth in exports from transition countries indicates structural change and effects of economic opening up, which for some CEEC countries involves specialization in the production of certain ICT products. To the extent that ICT production is strongly associated with productivity growth, such a pattern of specialization will contribute to higher output growth, reinforcing economic catching-up. From this perspective, two countries (i.e., Estonia and Hungary) indeed demand special attention. They recorded FDI by multinational companies (MNCs) in the ICT sector (e.g. IBM,

[53] The data are aggregated from the following Standard International Trade Classification (SITC) subgroupings: (1) 764.1 Electrical apparatus for line telephony or line telegraphy (including such apparatus for carrier-current line systems). Telephone sets, teleprinters, telephonic or telegraphic switching apparatus, other apparatus for carrier-current line systems, other telephonic or telegraphic apparatus. (2) 764.3 Transmission apparatus for radio-telephony, radio-telegraphy, radio-broadcasting or television, whether or not incorporating reception apparatus or sound-recording or reproducing apparatus. Transmission apparatus; transmission apparatus incorporating reception apparatus. (3) 762.81 reception apparatus for radio-telephony or radio-telegraphy; and (4) Parts and accessories suitable for use solely or principally with the apparatus of sub-group 764.1. Expressed in U.S. dollars.

Philips, Sony, Nokia, Samsung, Ericsson and Siemens) which used the new plants mainly for exporting to international – including EU-15 – markets.[54]

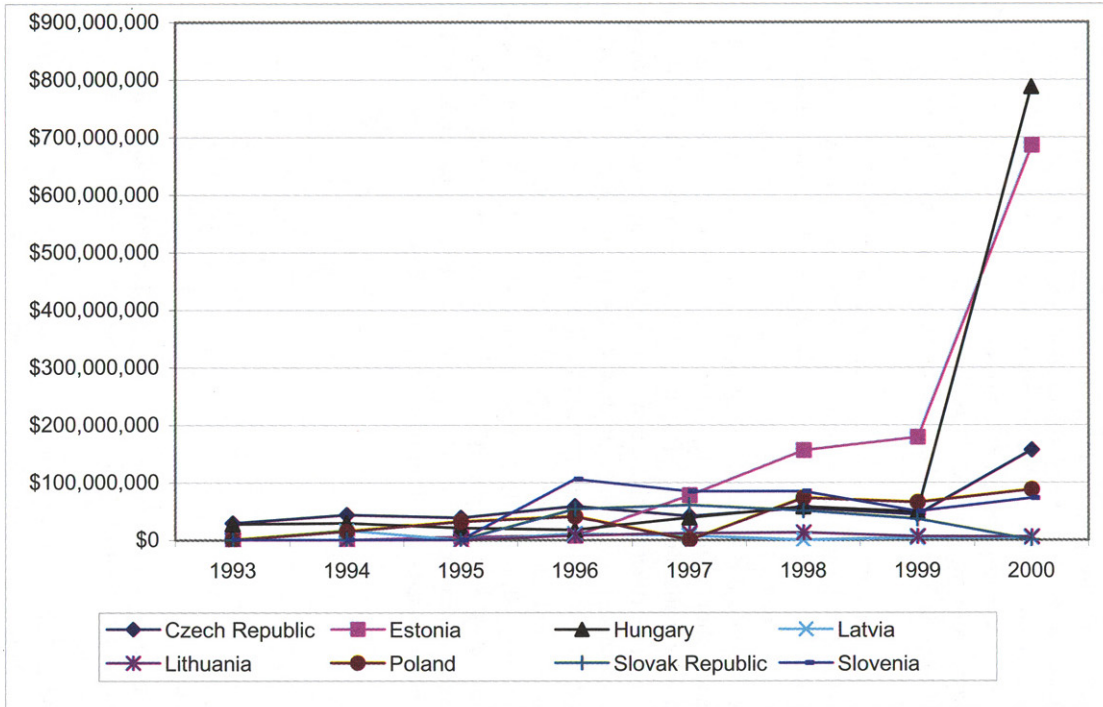
It is not clear whether the EU-10 have dynamic comparative advantages in electronics or in the production of telecommunications equipment. Several MNCs have started to move plants to more lucrative locations (e.g. Bulgaria, Romania or China) after an initial phase of FDI in Hungary. This brought considerable unemployment in that industry in Hungary, with several thousand skilled workers being affected. With a real appreciation of currencies of CEE countries, the relative wage advantage of other locations will rise over time.

The question now arises as to whether creating links from old industrial structures of transformation economies to the dynamic networks of the world economy can be interpreted in terms of shallow or deep integration (Szalavetz, 2002). It is well known that the incorporation of existing industrial organizations into the vertically integrated production networks of MNCs can bring major short-term benefits, but it is doubtful that it brings a major contribution to the process of systemic transformation. Certainly from a medium-term perspective, there could be positive technology spillover effects and human capital upgrading, gradually leading to a sectoral specialization associated with a more intensive use of immaterial assets in production and more innovation activities.[55] This change can bring countries on a comprehensive path of deep integration with part of the international production network in the export sector being characterized by elements of the New Economy. Ireland, for instance, has set a good example in industrial modernization based on FDI inflows into the ICT sector.

[54] The mentioned companies specialize in different areas of the ICT sector, including telephone exchanges and handsets, monitors, audio devices, monitors and TV sets (Radosevic, 2002).

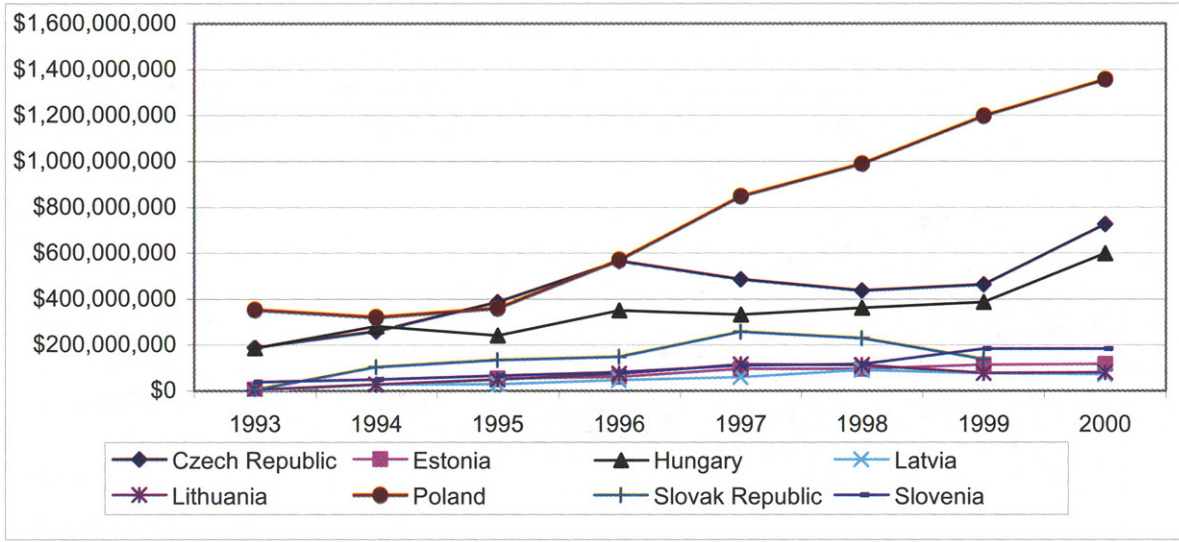
[55] MNCs have gradually been creating R&D centres in the EU-10, i.e. IBM in Prague, and Nokia, Ericsson and Xerox in Budapest.

Figure 6: Export of telecommunications equipment in CEECs, 1993-2000 (in $ million)



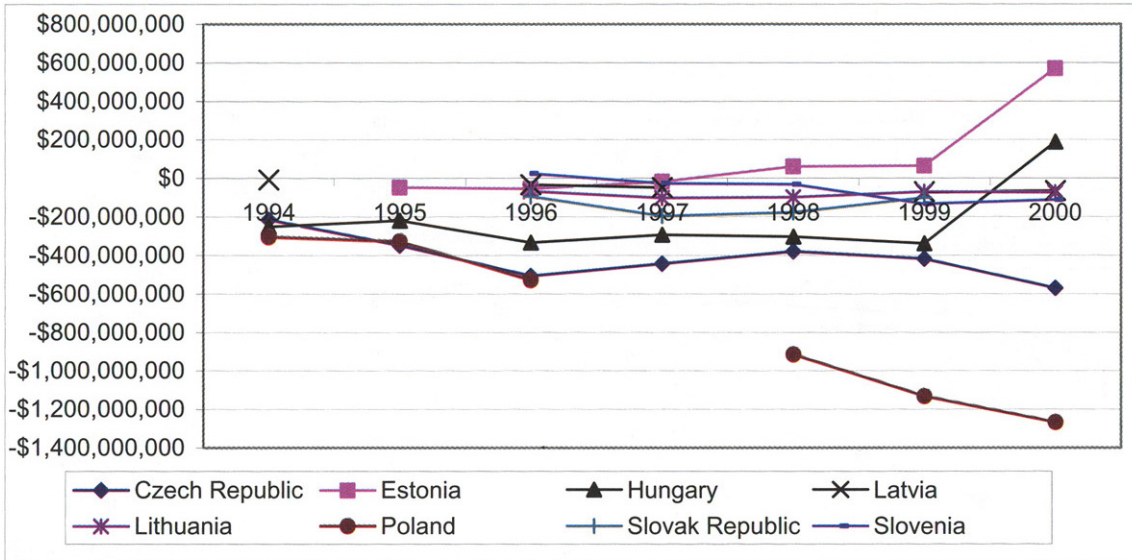
Source: ITU (2002)

Figure 7: Import of telecommunications equipment in CEECs, 1993-2000 (in US $)



Source: ITU (2002)

Figure 8: Balance of trade in telecommunications equipment in CEECs, 1993-2000 (US$)



Source: ITU (2002)

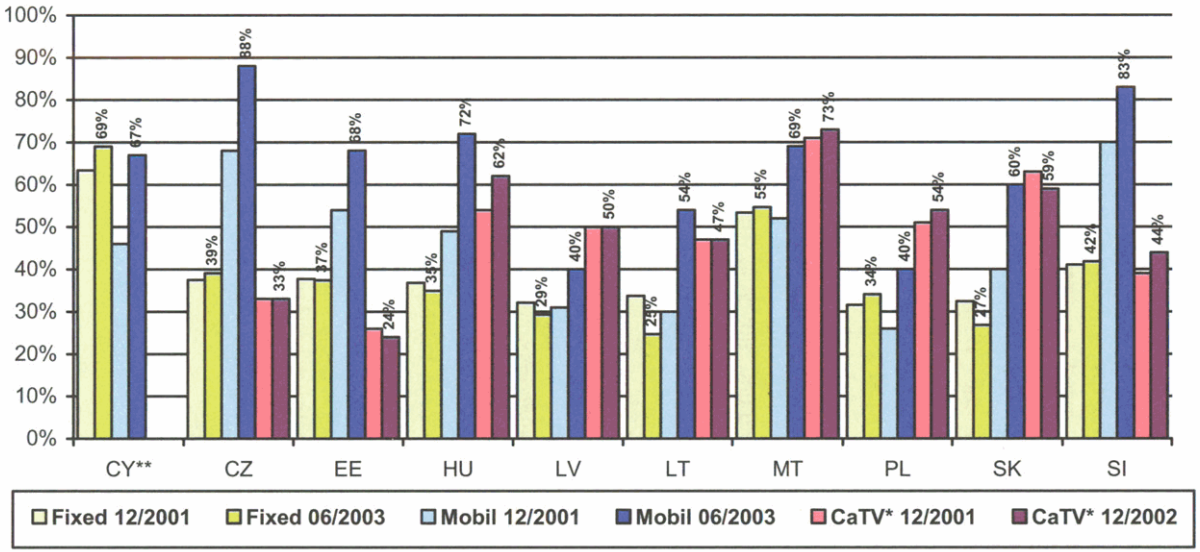
3.1. Extension of Telecommunication Infrastructure

The EU-10 have achieved a high level of the extension of telecommunication infrastructure and digital modernization of infrastructure, although there is still the need for improvement especially in rural areas. Statistics for the number of fixed lines per 100 inhabitants shed light on a very interesting – specific for Central and Eastern European countries – development. Owing to the liberalization processes, vast investment programmes by ex-monopolists as well as a rapid expansion of newcomers, the fixed telephone household penetration rate rose significantly over the last 12 years in nearly all of the EU-10, up to a level of nearly 70 per cent of all households. Since 2001, however, this quota has sunk in all countries except Slovenia. Similar observations can also be made on the basis of fixed telephone penetration rates referring to the number of inhabitants, with the exception of Cyprus, Poland and Slovenia, where the rates have increased (see figure 9).

The observed decrease in the connections of fixed telecommunications can be interpreted twofold: on one hand, from the market efficiency gap perspective and on the other, from the access gap (World Bank, 2002). First, because of slow market liberalization of telecommunications, optimal performance of the fixed telecommunications sector has not been achieved. In Central and Eastern European countries, for example, the prices for telecommunication services are still high, and the popularity of enhanced telecommunications access (e.g. ISDN or xDSL)[56] remains very low. Existing gaps can be corrected through market mechanisms, assuming the existence of effective regulatory institutions. Second, the access gap in CEECs must be recognized. In this case, it refers to the limitations of the market (i.e. in spite of efficient and highly competitive markets, some services cannot be delivered because of a lack of profitability). The need for State intervention in the form of State assistance (e.g. public subsidies based on competitive principles) can help in eliminating this gap.

[56] xDSL means x Digital Subscriber Line. X behind DSL represents different types of DSL (e.g. A, H, M, RA, S, V).

Figure 9: Basic communication access infrastructure in the EU-10: fixed and mobile telephone and cable-TV penetration rates (connections per 100 inhabitants*)



Note: * Cable TV penetration rate relates to the percentage of households passed by cable TV Operators; ** In Cyprus, there is no cable TV operator.

Source: PWC (2002) and IBM (2004)

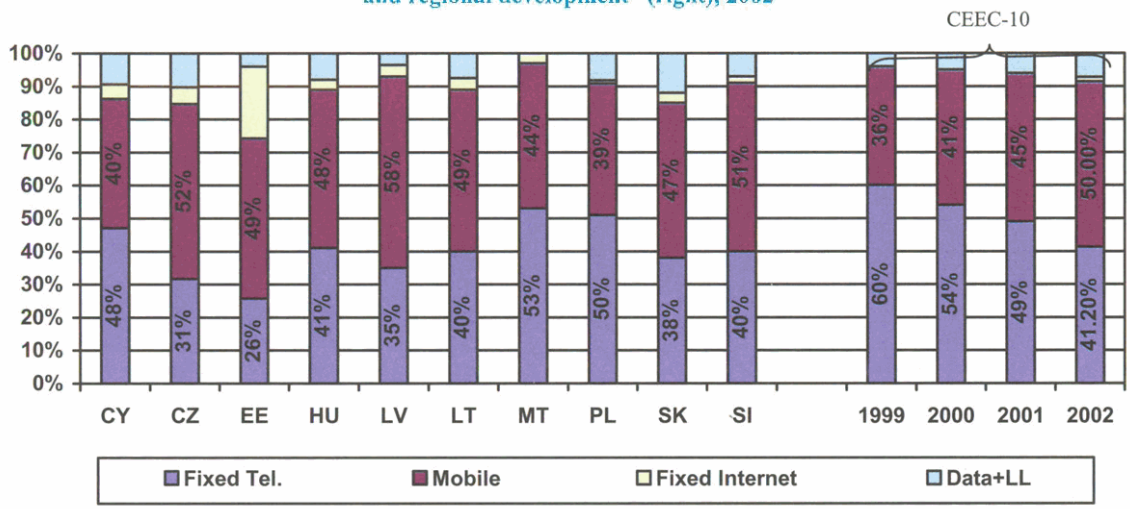
Emerging new markets, such as cable TV (offering bundled telecommunications and internet services for households more and more frequently) or cellular telecommunications, gradually take over some group of customers and wean new ones (figure 10). These communications platforms have been expanding since the beginning of the 1990s and have gradually become substitutes for fixed telecommunications. The average investment needed for the creation of one connection for both cellular service and cable TV does not exceed $730, which, in comparison with traditional fixed telecommunications, is considerably different.[57] One might suspect that the emergence of new communications networks influences the performance of fixed networks, simultaneously boosting the development of competition within the sector. Raghbendra and Majumdar (1999) have proved a positive and significant impact of cellular technology diffusion on the competitiveness of the telecommunications sector in OECD countries in the period from 1980 to 1995.

The above-mentioned market structure change relates to market revenue developments. In 2002, revenue from mobile telecommunications exceeded revenues from traditional fixed telecommunications in seven of the ten countries. Moreover, mobile telecommunications is seen as highly remunerative. One can expect that this tendency within fixed telecommunications can be changed in the EU-10, if coupled with the development of broadband access (figure 11) that boosts the development of Internet. Up to now, however, the development of ISDN or xDSL access technologies has been quite sluggish.

The development of broadband access technologies was introduced very late in the EU-10. At the beginning, the main aim of the sector was to achieve an appropriate level of accessibility to basic telecommunication services. Based on Welfens and Graack (1997), similar tendencies could be observed in EU countries with a poor telecommunications infrastructure at the beginning of 1990s (e.g. Spain, Portugal and Greece). Initial implementation of ISDN in some of the EU-10 (i.e. in Poland and Estonia) took place in 1994 and has not won much popularity up to now.

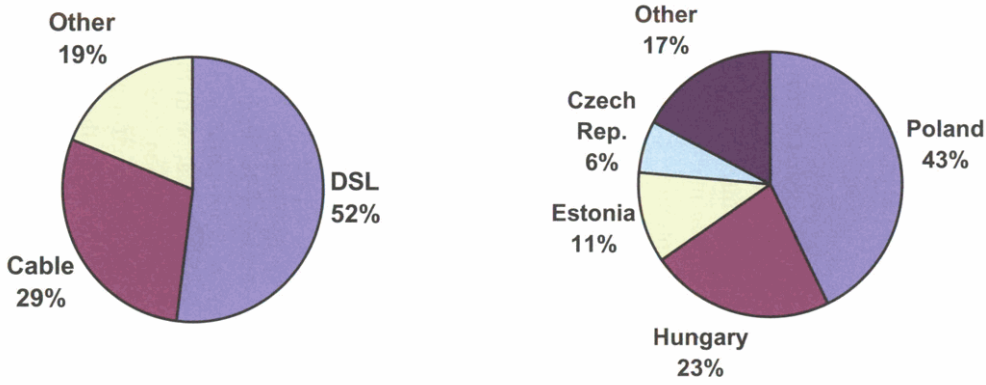
[57] For a comparison of investments in fixed telecommunications, see the beginning of chapter 3.

Figure 10: Telecommunications market segmentation in the EU-10 (left) and regional development* (right), 2002



Note: * - Cyprus, Malta has been excluded, LL - leasing of lines.
Source: PWC (2002), IBM (2004), own calculations.

Figure 11: Broadband connections in the Czech Republic and Slovakia in 2003 (left*) and share of broadband connections in selected countries of Central and Eastern Europe in 2002 (right)**



Source: *Budd, J. (2003), DSL Boosts Broadband Services in the Czech Republic and Slovakia, IDC and **Budd, J. (2003), Central and Eastern Europe Broadband Access Services and Analysis, 2002-2007, IDC.

These services have mostly been directed to the business customers. The developments on the xDSL market depict another situation. Although first attempts at broad implementation of xDSL on the market took place at the turn of year 2000/2001, the market has grown exponentially after its implementation, achieving better density than that of ISDN. Nowadays, xDSL has become the biggest impetus of growth in broadband access within the EU-10, reaching approximately twice the number of subscribers in 2003 (820,000) as in 2001 (400,000). In 2003, the broadband market value is estimated at $467 million (ITU, 2004).

The role of cable TV operators in broadband diffusion within Central and Eastern European countries should not be overlooked. For four years, a rapid expansion of operators in this market of Internet access has been observed. These technologies dominate especially in markets in which DSL rollout has not yet taken place. The positive reception of DSL[58] has gradually changed business circumstances. Strong competitiveness between different broadband access modes can be expected. Especially the rapid rolling out of wireless technologies could play a significant role here. Additionally, the increasingly frequent implementation of modern business strategies in the ICT sector – for example, bundling (e.g. the provision of Internet, telephone and cable TV services as a package plan) makes the situation more complex and promotes the implementation of new developments in terms of market structure (i.e. market convergence by means of mergers, acquisitions and joint ventures); or legal aspects (i.e. introduction of new regulatory regimes concerning convergence developments) – play an important role here.

As mentioned above, new wireless technologies for broadband access play a significant role in CEECs. In terms of technological advancement and diffusion, the rates in the EU-10 are near, or sometimes even exceed, those of EU counterparts. Roots of wireless communication in the EU-10 can be dated back to the beginning of the 1990s, when the first analogue radio-communication systems were implemented. High usage costs, the quality of law services as well as narrow possibilities for the implementation of value added services have been slowing down the broad implementation of mobile

[58] It should be mentioned that most telecom providers offered broadband access mostly to business customers until the end of 2001.

telecommunications. The initial introduction of second generation digitalized technologies allowed the market to expand.

The average density of mobile telecommunications within EU countries in 2003 was 81 per cent, while only about 43 per cent in Central and Eastern Europe (IBM, 2003). There is still huge potential for investment and development of infrastructure.

In Central and Eastern European countries, mobile operators also paid for the 3G/UMTS licences, between $9 per capita in the Czech Republic, up to $45 in Slovenia and nearly $51 in Poland. This, however, is nothing compared to the $600 spent in Western countries. Thus countries could concentrate merely on the geographic rolling out of the existing system and not on the extent of market scarcity in investment capital.

In terms of penetration, the development of mobile telecommunication in the least developed markets is worth mentioning. They expand very quickly, and the regional penetration is expected to reach 73 per cent in 2007. In 2002, regional spending on mobile services amounted to $9.2 billion. The significance of short message services (SMS) in revenues increased to 15 per cent in 2002, up from 10 per cent. In 2002, data and SMS accounted for 7 per cent of all revenue in CEE. SMS services alone accounted for 6.7 per cent of all revenue (Ludwiczynski, 2003). New services, such as multimedia messaging services (MMS) and other general packet radio service-based applications, have been launched across most of the region and are gradually picking up usage. Universal mobile telecommunication systems should spread rather rapidly across the region in the near future, but its commercial success and significant usage levels are more long-term prospects.

4. Policy conclusions

From a policy perspective, it is crucial that competition is strengthened in the different market segments in the EU-10. For small countries – such as the Baltic countries – this might require regional network integration. Finland has shown that even in a relatively small country, there can be strong competition. Internet competition in local access markets is also crucial. The unbundling requirement of the EU framework regulation is important, as it will force some of the EU-10 to establish competition in the access market, which in turn

should help to bring down prices for internet use. For the business community, broadband internet access will be quite important, leading to a greater need for the expansion of DSL, cable networks and mobile broadband technology.

As several network operators from EU-15 have invested in fixed line telecommunications or in mobile network providers, the prospects for the EU-10 to catch up with EU-15 are rather favourable. Sustained high aggregate output growth will stimulate the demand for telecommunication services. And the presence of many multinational companies in Central and Eastern Europe – above all, in Hungary, the Czech Republic and Poland – will add to sophisticated demand for digital value-added services. Mobile telephony is likely to be more important than fixed line telephony in the medium-term, since competition in mobile telecommunications is more intense than in fixed line telecommunications where the dominance of the former monopoly operator is quite obvious in all transition countries of Eastern Europe. Within the EU-10, there is a clear digital divide between metropolitan areas and the countryside or peripheral regions. If this telecommunications gap should continue, there are grim prospects for poorer regions to catch up with national average in terms of per capita income. National Governments and the EU should therefore closely monitor the extent of the digital regional gap in Central and Eastern European countries. It might be useful for the EC to encourage the use of structural funds to invest in the expansion and modernization of telecommunications in poorer areas.

Digital modernization of government and public administration will also be useful for improving productivity and growth in the EU-10. However, a lack of skilled personnel could be a problem in both the public and the private sectors. As one may indeed expect that increasing the use of ICT goes along with a higher demand for skilled labour, it would also be reasonable to expect a rising wage premium to the favour of skilled workers. It would be wise for Governments in the EU-10 to increase government expenditures in the field of education and retraining while putting particular emphasis on learning with and about modern software as well as advanced communication opportunities.

As regards options to attract high FDI in the ICT-producing sector, there are some natural opportunities for Estonia to benefit from ethnic links with Finland. Hungary offers relatively skilled labour and a long tradition of software development, which might help to nurture the software sector in

Hungary while simultaneously attracting producers of ICT equipment. Poland has the advantage of a relatively large domestic market, a relatively good skill base among workers and close proximity to Scandinavia and Germany. This could be seen as a considerable incentive among producers from those countries that seek to exploit the relatively low wages in Poland. However, it does not mean that Poland should be expected to strongly specialize in technology intensive products. Taking a closer look at the production process, one will typically find that assembly-line production is dominant in the electronics field. Only in the long run will opportunities for moving up the technology ladder gradually present themselves, namely as R&D intensity increases over time. This, in turn, requires that long-term government spending on the promotion of R&D – relative to GDP – must increase.

Table 2
Period needed for economic catch-up: EU-10 and selected EU members*

EU countries	GDP per capita, PPP ($)2002	Years needed to catch up to the EU average hypothetical average economic growth rates				
		1%	*2%*	*3%*	*4%*	*5%*
Slovenia	18.000	39	19	13	10	8
Malta	17.000	44	22	15	11	9
Czech Rep.	15.300	55	28	19	14	11
Cyprus	13.300	69	35	23	18	14
Hungary	13.300	69	35	23	18	14
Slovakia	12.200	78	39	26	20	16
Estonia	10.900	89	45	30	23	18
Poland	9.500	103	52	35	26	21
Latvia	8.300	117	59	39	30	24
Lithuania	8.400	115	58	39	29	24
EU-10 average	**12.620**	**74**	**37**	**25**	**19**	**15**
Spain	20.700	25	12	8	6	5
Greece	19.000	33	17	11	8	7
Portugal	18.000	39	19	13	10	8
EU-3 average	**19233**	**32**	**16**	**11**	**8**	**7**
EU-15 average	**26466**					

Note: *For the simplification of analysis it has been assumed that the average GDP of EU-15 is constant during catch up process. Demographic developments over time have not been taken into consideration.

Source: Own calculations based on data from the World Fact Book (2002).

There is no doubt that digitization and modern telecommunications will stimulate trade and investment in the new EU-25. From this perspective, it will be important that regulators adopt a regime consistent with the *acquis communautaire* that also stimulates economic development. One may anticipate that within a decade, some of the EU-10 Member States will come close to the indicators of EU average.

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Chapter 2.2

Reducing Technical Barriers to Trade: Regulatory Convergence and Harmonization – The Case of the Telecommunications Industry

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The telecommunications sector is today truly global. Products are being designed and manufactured with a global market in mind. However, for aspects of a product that is subject to "regulatory approval", there are large differences in the regulatory requirements, both technical and administrative, of the major economies. This poses technical barriers to trade, resulting in considerable extra costs for manufacturers and delays in getting products on the markets.

In order to improve the situation, active discussions and actions are needed on alternative and streamlined methods for product approval. This paper describes some elements forming possibilities for such a change in the approvals of ICT products. It suggests a possible way forward to depart from bureaucratic systems, and arrive at systems built on trust and on applying recognized regulatory objectives as a basis for ICT products to be traded globally. Such an arrangement has been suggested by the UNECE in their Telecom Initiative, which uses the UNECE "International Model for Technical Harmonization".

The paper suggests a possible way to advance discussions in WTO and how to combine a possible WTO agreement regarding principles for regulation for market access with the UNECE International Model as a platform to develop technical regulations.

1. Technical barriers to trade in the approvals of telecommunications products

The present product approval procedures for a particular market normally consists of a number of requirements. These can be classified into two groups:

- Technical requirements
- Administrative requirements.

To a large extent these still differ between markets, although there is little (if any) need for such differences, as discussed below.

1.1. Technical requirements

Within the telecommunications sector, there are a number of policy objectives that products have to meet in the course of approval. In most cases these are related to:

- Safety of persons
- Avoidance of radio disturbance
- Spectrum efficiency in case of radio application
- Attachment to a telecom network in case of terminal equipment.

In recent years there has been an increasing use of international standards, although in certain cases still with some national deviations, to define the technical requirements that reflect the policy objectives. This positive trend is continuing. There will be less national or regional deviation from international standards in the future. The benefits of global standards are more clearly and insistently voiced by industry and other stakeholders. National regulatory bodies are more inclined to find a common understanding regarding which policy objectives need to be covered by "mandatory standards". They generally favour the use of standards that are transposed from international standards to meet these objectives.

The link between standards and policy objectives is maintained since the standardization process is influenced by regulatory bodies, especially when the standardization work is a question of standards intended for regulatory purposes.

1.2. Administrative requirements

Administrative requirements in technical regulations are usually the major cause for trade barriers, or will at least have the effect of posing de facto barriers for a supplier wishing to enter different markets. This is particularly the case for SMEs where the costs for gaining multiple approvals may become overly onerous.

There is a wide range of administrative requirements related to product approvals:

- *The conformity assessment method* required may involve mandatory use of third party for testing and/or approval. Often only national third-party test houses are allowed to perform these tasks. This adds considerably to costs and time delays in getting approvals. The need for such rigid requirements can be questioned since in the end it is always the supplier that has the responsibility for the product's compliance with technical regulations irrespective of whether a third-party test house has been used or not.
- *Technical information* required to be supplied in the course of approvals can be excessive. Often this has to be translated – to satisfy regulatory/approval bodies – into the various national languages, which further adds to cost and time delays.
- *Labelling* requirements differ, since these are usually intended for the market in which the product has been approved. Normally the labels have to be on the product itself, which adds to the costs. Recently, increased attention is being paid to the trade-restrictive aspects of labelling, notably in OECD.[59] More discussions are called for in order

[59] See OECD document TD/TC/WP(2002)40/FINAL, dated 13 November 2003: "Analysis of non-tariff measures – The case of labelling: Overview and analysis of WTO data".

to come to relevant solutions, notably to avoid excessive regulatory labels and to permit these to be in the documentation rather than on the product itself.

1.3. The role of Mutual Recognition Agreements/Arrangements

A number of Mutual Recognition Agreements/Arrangements (MRAs) have now been concluded between countries and regions. The establishment of these MRAs have had some useful effects, mainly beyond their intended purpose, as described below.

1.4. Highlighting differences between regulatory systems

MRAs allow the approval procedures to take place in the exporting country's territory, using local approval bodies. The agreements do not, as such, require any harmonization or changes of rules. However, one of the most important aspect of MRAs is that the regulatory procedures and technical requirements of the parties are fully transparent (so as to enable them to be applied by the other party). This transparency has the effect of highlighting the existing differences between the participants' systems and inevitably raising the question as to why they differ.

It can be presumed that the reason for the countries to apply the requirements is to safeguard one or more public interest objectives, but why is one party satisfied that this can be done with less bureaucracy and/or fewer requirements than the other? Is it possible to facilitate increased trade between countries by reconsidering the existing approvals requirements towards a less burdensome regime? These questions can be resolved via discussions between regulators.

1.5. Regulators entering into discussions

MRAs have triggered regulators in different countries and regions to engage in regulatory discussions, not only on MRAs but on general matters related to technical barriers to trade. This has become a very valuable side effect of MRAs. However, MRAs do not include provisions for initiating regulatory reforms, so any simplification of regulatory requirements will be initiated by a party on its own initiative.

The WTO Technical Barriers to Trade (TBT) Agreement[60] does contain some general principles on the content and trade implications of national technical regulations, but any discussions in WTO on these matters merely takes the form of information exchange between members, rather than taking action to simplify approvals to enable trade.

1.6. Industry cooperation due to MRA

In order to give the telecom industries' views of the MRA that was being negotiated between the EU and the United States, special industry task forces on both sides of the Atlantic were established in 1996. When the MRA was negotiated between the EU and Japan, similar industry cooperation was established. This cooperation made it possible to explore the benefits and drawbacks of each region's regulatory systems, and as a result, agree on a joint industry paper describing the ICT sector's views on conformity assessment ("Green Paper on a Global Product Conformity Assessment for the Future").

Since the ICT sector is in fact global, with products that from a technical point of view are suitable for use in different regions without alterations, there is much to be gained from regulatory convergence and regulatory simplifications so as to minimize the regulatory burdens for products intended for a global market.

1.7. Opportunities for change through WTO processes

The best way to reduce trade barriers is to deregulate as much as possible, relying more on general competition and consumer protection laws. This is of course a one-sided action only but the effect is generally very positive,[61] and it encourages the trading partners to do the same. Thus, as a general rule,

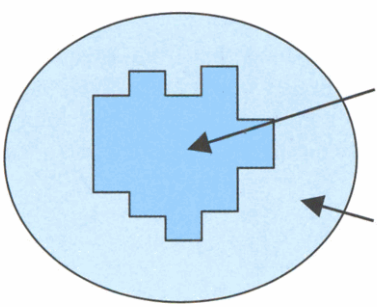
[60] For more information on the WTO Agreement on Technical Barriers to Trade, see http://www.wto.org/english/docs_e/legal_e/17-tbt.pdf)

[61] As an example, with its radio and terminal equipment directive ("R&TTE directive") 1999/5/EC the EU removed all specific regulatory requirements for terminal attachment to public networks and reduced the regulatory requirements for radio equipment. This has led to a large increase in availability of innovative ICT products on the European markets.

deregulation should always be looked at as a first option when reviewing existing legislation.

Meanwhile, the WTO TBT Agreement sets the limits for "maximum" regulation. It also provides for possibilities to reduce unnecessary trade barriers. However, the full potential of the agreement as a "trade enabler" as not yet been seen. Some of its elements are open to interpretation. For example, the meaning of the concept "least trade restrictive" is rather vague, and can be interpreted in various ways. Hence, it is possible to have widely diverging measures while still formally being compliant with the principles in the WTO TBT Agreement.

Facilitation of market access, i.e. to go beyond "unnecessary obstacles" to ensure full market access, is still missing from the TBT agenda (see figure below).



There are some developments in WTO TBT Committee however. Trade obstacles for the ICT sector is an issue being actively discussed:

- A work programme[62] on non-tariff measures under the "Ministerial Declaration on Trade in Information Technology Products" (ITA) umbrella was established in 2000.

[62] WTO Committee of Participants on the Expansion of Trade in Information Technology Products: "Non-Tariff Measures Work Programme", dated 13 November 2000: http://www.wto.org/english/tratop_e/inftec_e/19.doc

- A learning event on labelling was held in October 2003.
- A symposium on non-tariff barriers (and some other related issues) for IT products was held in October 2004.
- As a result of the third triennial review, a workshop on the use of Supplier's Declaration of Conformity (SDoC) was held in March 2005, to be followed later by a workshop on the different approaches to conformity assessment.

OECD has also done some studies on non-tariff measures in the ICT sector. Two papers were prepared[63] during 2001, identifying opportunities for harmonization. However, work is needed to reach some more conclusive results. OECD has also done an analysis of data on labelling.[64] a subject that merits much further attention.

The recent Asia Pacific Economic Cooperation-OECD cooperative initiative on regulatory reform[65] is an interesting step towards guidance for simplification of regulatory procedures for the participating countries. The "Integrated Checklist on Regulatory Reform" that is being developed would provide a good description of important aspects to consider in regulation, by addressing issues not only related to regulatory policies, but also to how regulatory policies impact on competition and market openness.

[63] OECD Working Party of the Trade Committee: "Standards-Related Barriers and Trade Liberalisation: Telecommunications Sector", TD/TC/WP(2001)11/FINAL, dated 07 March 2002: http://www.olis.oecd.org/olis/2001doc.nsf/linkto/td-tc-wp(2001)11-final; and OECD Working Party of the Trade Committee: "Non-Tariff Measures in the ICT Sector: A Survey", TD/TC/WP(2001)44/FINAL, dated 11 September 2002:http://www.olis.oecd.org/olis/2001doc.nsf/linkto/td-tc-wp(2001)44-final.

[64] OECD: "Analysis of Non-Tariff Measures – The Case of Labelling: Overview and Analysis of WTO Data", TD/TC/WP(2002)40/FINAL, dated 13 November 2003: http://www.olis.oecd.org/olis/2002doc.nsf/linkto/td-tc-wp(2002)40-final

[65] See, for example, the "general information and draft agenda" for the APEC-OECD sixth workshop on regulatory reform, available via http://www.apecsec.org.sg/apec/highlights/sixth_workshop_of.html

It is recognized that within the framework of WTO there is no provision for agreements resulting in concrete global measures to reduce technical barriers to trade. Members can, however, simplify their regulatory measures based on discussions being held in WTO and other forums, or as a result of a general opening-up of their markets and stimulating trade. This will take place at different speeds in different countries.

So how can concrete results regarding the harmonization and simplification of regulatory systems be achieved under existing circumstances? Here the UNECE International Model[66] for Technical Harmonization can play a major role.

2. Using UNECE work

2.1. The UNECE International Model for Technical Harmonization

To support the work done in the WTO and the OECD and to provide a practical tool for reducing technical barriers to trade, the UNECE Working Party on Regulatory Cooperation and Standardization Policies (WP.6)[67] has developed Recommendation "L" - the International Model for Technical Harmonization. Its stated aim is to "provide a voluntary framework which could contribute to facilitating market access through the establishment of sectoral agreements between interested member countries". Participation is open to all United Nations Member States.

The agreements between participating member countries are written as common regulatory objectives (CROs) that contain the regulatory provisions including conformity assessment procedures and references to relevant (preferably international) standards. The participating member countries

[66] UNECE Recommendation "L" "An International Model for Technical Harmonization based on Good Regulatory Practice for the Preparation, Adoption and Application of Technical Regulations via the Use of International Standards", 14 June 2002, http://www.unece.org/trade/ctied/wp6/documents/ wp6 02/wp6-02-07e.pdf

[67] For WP.6 activities, see: http://www.unece.org/trade/ctied/wp6/

themselves determine the content of the CROs, e.g. the appropriate conformity assessment method and which standards to use.

The CROs would apply in parallel to the existing national regulation and would allow the free circulation of the identified products in all countries agreeing on the CRO(s) in question.

2.2 The Telecom Initiative

The possibility of applying the International Model for products in the ICT sector was suggested during a meeting[68] of the UNECE "START" Team[69] in April 2002 where representatives from the industry were also present.

It was agreed to prepare, as a first step and to provide a trust-building opportunity for Member States, draft CROs for a selected number of truly global and well-known ICT products, namely:

- Personal Computers (PC) and their peripherals
- Terminals for attachment to the legacy Public Switched Telecom Network (PSTN)
- Bluetooth products
- Wireless Local Area Network (WLAN) products
- GSM products
- IMT 2000 family products.

Following some meetings, draft CROs have been prepared[70] under this "Telecom Initiative". Today many products are multifunctional, and therefore one product may contain several of the functionalities mentioned above. Mindful of this fact, it is important that the administrative procedures be kept equal for all of them, and therefore it has been suggested to have one common

[68] See http://www.unece.org/trade/ctied/wp6/sectoral/telecom/telc_bkgrd.htm for details.

[69] Ad hoc Team of Specialists on Standardization And Regulatory Techniques, the team that prepared the International Model.

[70] http://www.unece.org/trade/ctied/wp6/sectoral/telecom/telc_cros.htm

CRO for the administrative aspects of all the listed ICT products, while separate CROs cover the technical requirements.

The administrative requirements include the reliance on assessment performed by the suppliers themselves, with an SDoC[71] providing evidence of compliance. This is then complemented by a market surveillance function performed in the participating countries by their responsible authorities. These elements follow the principles for an optimum regulatory system described in the industry paper "A Common Approach to Regulation for Market Access of ICT/CE products".[72]

Since international standards are not available in all cases for the selected products, or there are regional differences to the international standard, the technical requirements in the draft CROs in some cases contain references to regional standards. In some cases there are duplications of requirements. Such differences or duplications should disappear in due time through the normal standardization process, as discussed above.

Preferably, in the longer term, CROs should be based on phenomena (electro-magnetic compatibility, safety, etc) rather than on products, to provide a more horizontal framework for the ICT sector.

2.3 The UNECE International Model as a complement to WTO procedures

The TBT Agreement covers all industry sectors. It is realized, however, that the ICT sector has moved more quickly than other sectors towards open market access for global products. With the removal of tariffs for ICT products, non-tariff barriers become more visible for this sector, thus calling for further alignments and simplifications of regulatory systems towards ensuring full market access for ICT products.

[71] For details on the contents of SDoC, see standard ISO/IEC 17050-1:2004 "Conformity assessment – Supplier's declaration of conformity – Part 1: General requirements".

[72] See www.eicta.org

Based on conclusions drawn from the studies of SDoC and conformity assessment within WTO, conditions for optimum market access, i.e. a "Common Approach to Regulation for Market Access of ICT Products", could be discussed within the International Technology Alliance Committee. This would represent the "best regulatory practice" for the sector.

Such a Common Approach could then be complemented by discussions among members on a common set of technical regulations that members may want to implement in their national regulation. It is recognised that such work is not within the terms of reference of WTO but could be done within the framework of the UNECE International Model.

Using the International Model, members wishing to establish favourable market access conditions among themselves would develop CROs in line with the agreed Common Approach. These CROs should define legitimate objectives with a minimum of bureaucratic measures, rely on SDoC and the use of international standards. As described above, the UNECE Telecom Initiative already suggests CROs for some global ICT products.

3. Conclusion

It is important that discussions on the reduction – and ultimately removal – of technical barriers to trade continue in WTO and other forums. ICT products are vital for a country's economic development and every effort should be made to facilitate the availability of such products.

As a complement to reaching agreement on the principles of a "Common Approach to Regulation for Market Access of ICT products" in WTO, the UNECE International Model can provide the necessary platform for developing the corresponding technical regulations that countries can use to enable such favourable market access conditions. As suggested in the UNECE Telecom Initiative, these technical regulations should include non-bureaucratic measures, rely on SDoC and the use of international standards. This would provide for open market access for the ICT products among countries taking advantage of this system.

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Chapter 2.3

Unifying the European Payments Landscape

Mr. Marc Temmerman, Executive Vice President, External Relations, VISA Europe

As everyone knows, one of the central objectives of the EU has been to create a single European market – where there are no barriers to trade or commerce across any of the member States.

Although the EU has made huge strides in this direction, several obstacles continue to stand in the way of the vision. In particular, cross-border retail payments have been seen as unduly slow and expensive.

Although the media may enjoy pointing the finger of blame at Europe's retail banks, the countries of the EU (just like countries everywhere else in the world) have, in fact, independently created a patchwork of parallel, incompatible payment networks.

Given that the vast majority of payments have always been – and continue to be – domestic, there has never been a compelling business case to form linkages between each of the national infrastructures.

The net result is that, yes, cross-border payments have been slow. They have been expensive. And this is generally reflected in the price and the quality of service experienced by businesses and consumers alike.

The one notable exception is the card payment sector. Ever since it was first created, the card system has effectively "overlaid" a series of domestic payment schemes with international functionality and interoperability.

In doing so, it has enabled highly convenient, highly secure, generally instantaneous cross-border and multicurrency payments. And it has done so at minimal cost.

Frustrated at the lack of progress across other types of retail payments, the European Commission is taking a tougher stance. It has already introduced payment-related legislation. And it has insisted that Europe's banking community must now progress to a Single European Payments Area (SEPA), where any regional payments can be made as easily and cheaply as in one's own hometown.

It is therefore worth reflecting whether the card payment sector – either directly or by example – has a role to play in achieving these objectives.

1. Microeconomic benefits of cashless payments

On the microeconomic level, commercial payment cards bring huge benefits to individual enterprises.

Internationally held and internationally accepted, these products give any enterprise a fast, cost-efficient means of multicurrency payment and, crucially, a guaranteed means of payment.

In addition they help to manage cash flow. They also provide ease of access to appropriate funding, whether that be on deposit or a line of credit. Plus, they bring reductions in administrative costs and a means of tracking expenditure.

For larger companies, they can also support supplier compliance monitoring, and can be used to develop competitive buying policies.

A good indication of the potential comes from a card payment system used by the United Kingdom in a Procurement programme. Since it was introduced in 1997, this has provided the British Government with process cost savings of more than €151 million, and is expected to liberate further savings of €280 million over the next five years.

Corporate card issuance in the EU-10 is already well advanced. Enterprises in these countries are therefore finding that, as they widen their business horizons, the card system can remove many of the barriers associated with international and multicurrency payments.

2. Macroeconomic benefits of cashless payments

Perhaps more significant than the microeconomic benefits are the macroeconomic benefits.

By analysing the characteristics of any economy, it is generally possible to detect a clear correlation between the level of cashless payment and wider economic well-being. In other words, those economies with the highest levels of cashless payments tend to be the most prosperous.

Global Insight, a leading econometric forecasting agency, published a study that quantifies and verifies this relationship.

If you compare the total costs of an electronic payment system with an equivalent cash-based payment system, taking into account the scale effects and reduced friction, you see that the cashless system is one third to one half of the price.

And this, according to Global Insight, typically translates to aggregate cost savings of at least 1 per cent of GDP. Across the five largest European economies, this translates to around $58 billion in annual savings.

What is also important to appreciate is that the costs of the cash-based system are variable. More payments mean more cost. So the per-payment cost is high, and will always remain high.

The costs of the electronic system, however, are fixed. Once the infrastructure has been built, the per-payment costs become progressively lower.

Another factor is that, in order to participate in electronic payments, people must first participate in the banking system. And payment cards do have the effect of drawing people – en masse – into the banking system.

Much of the banking sector's growth in the countries having just acceded to the EU is direct evidence of this. It has been driven not just by banks but also by their corporate customers – purging cash and paper from the payroll system, and depositing salaries directly into employees' bank accounts. This is another way the card system benefits individual enterprises which, in turn, brings more benefits to the national economy.

Bringing people into the banking system has a huge transformational effect. It provides banks with a ready supply of low-cost funds, and makes them available for investment. It can be argued that every euro that circulates as hard cash is a missed opportunity to invest and develop and grow. And, once the money is in the system, it is accountable, which makes it harder for grey economies to function.

3. Speeding up the move to cashless payments – the net benefit

As well as investigating the macro-economic costs of cashless payments, Global Insight also looked at the way that cashless payments can lead to a direct increase in consumer spending.

They suggest that, in general, a 10 per cent shift in electronic payments will directly liberate a 0.5 per cent increase in consumer spending.

More specifically, they examined 21 European countries with a collective consumer spending of $5.27 trillion. They calculated that, if the share of electronic payments could be increased by just 2 per cent, around $26 billion in incremental consumer spending would be liberated.

Looking in detail at a number of Central and Eastern Europe countries Global Insight calculated that card payments currently account for between 0.7 per cent of consumer spending in Romania up to 17 per cent in Hungary. If that proportion were increased by just 10 per cent across these countries, an additional $1.5 billion in real consumer spending would be created. If it were raised by 50 per cent, $5.4 billion would be created.

Furthermore, additional consumer spending growth of this order could translate to between $1.7 and $8.2 billion in GDP to the region.

Chapter 2.4

The European Union: New Frontiers, New Issues

The Innovative Trade Network (ITN) and COTECNA

1. Overview

This paper describes a number of critical trade facilitation and security issues resulting from the expansion of Europe and European trade agreements, and at the same time proposes some potential models from supply-chain security solution providers.

The focus is on three main topics:

- The implications of the recent expansion of Europe (to 25 countries)
- The EU-Med Agreement Free Trade Area (year 2010)
- Trade facilitation in a secured trade environment.

The real challenge of EU enlargement is the coordination of an efficient EU trade policy with the 25 member countries, dealing with security as a critical element.

In addition to Turkey and Western Balkans, the EU has already granted preferential EU market access to the candidate countries (Bulgaria, Croatia, Romania and Turkey). This poses new security, control and coordination problems. Additionally, the implementation of the EU-Mediterranean Free Trade Area may present significant trade security and trade facilitation impacts for the region.

The most important issue involves how to address trade security while at the same time not hampering trade facilitation. Private industry has been called

upon to participate in addressing the trade facilitation and trade security issues. This paper presents some of the current private industry initiatives and solutions that can serve as models, but also links future challenges and opportunities for companies involved in EU trade issues.

2. The expansion of the EU has implications for trade security and trade facilitation

The EU expanded by 10 new countries on 1 May 2004, bringing the total EU members to 25. The expansion of the single market from 370 million to 480 million consumers, as a result of the enlargement, has the potential to stimulate economic growth and may provide new opportunities for business throughout Europe.

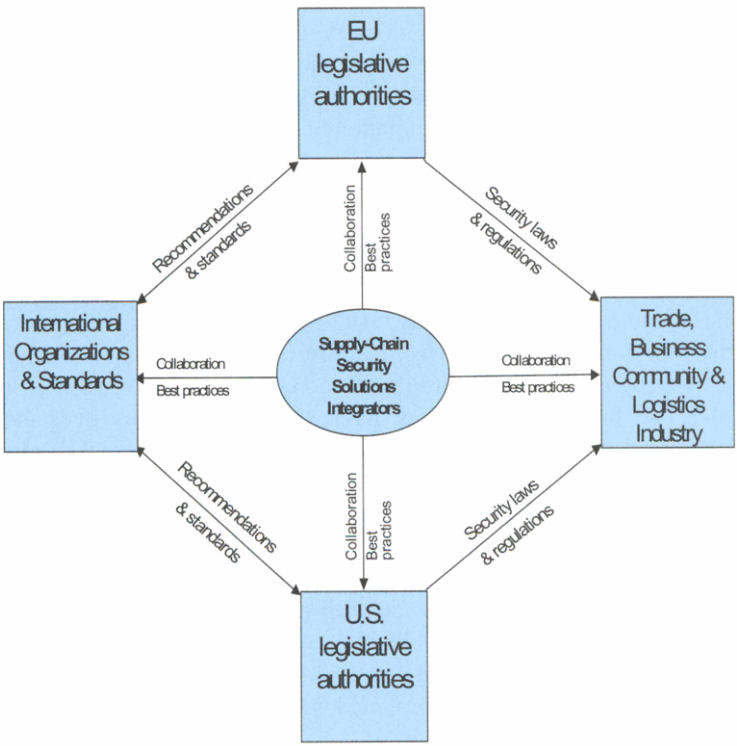
EU enlargement brings about new security challenges as well. The cornerstone here is the necessary coordination effort for an EU-wide trade security policy.

The borders have moved "out" (to include the EU-10), meaning that all the existing controls procedures have to be replicated by the EU-10 in a harmonized way. This implies a significant implementation effort involving the introduction of EU procedures and technologies.

The coordination of security policy inside the EC is a high priority. Two aspects are most important – the first aspect is the international coordination of the trade security, especially with the United States having implemented several trade security measures. "There are clear benefits in a co-ordinated approach between national administrations to risk management, incident response, data sharing, training and risk prevention". The second aspect is the involvement of the business community in a public-private partnership thus enabling an environment of mutual trust and facilitating the development of business-friendly measures.

Figure 1 represents the role of supply-chain security solutions providers within the international coordination of trade security policy and as a critical link between Government and business community.

Figure 1: Coordination of the trade security policy: actors and relations



The coordination of data sharing is one example of a security activity that would definitely benefit from consultation and partnership with the business community through providers of supply-chain security solutions. A major concern is the larger business community apprehension in providing the necessary information for security assessment (for commercial and confidentiality reasons). The presence of new trade actors from the EU-10 and their ways of doing business will require new ways of thinking and reacting. Also, the significant increase in the number of trade transactions precisely due to the entrance of the new trade actors from the new countries will result in significant increases in data volume and decision requirements.

One of the new WCO's recommendations is the provision of *advance cargo information* and the management of data not only from the actors in the supply chain but for all countries the goods that are passing through (country of entry, country of transit and country of final destination). In fact, all countries need to know the information about the cargo moving through the country, both normal imports and transit goods. For the support of advance cargo information, efficient dissemination of advance trade data is necessary.

Data clearinghouses will be needed to ensure necessary data flow management activities involving, data capture, data validation and dissemination.

One of the immediate concerns resulting from the recent terrorist attacks was the reinforcement of security measures. It is clear that these measures should be designed to have as little impact on the global movement of trade as possible. The business community has expressed concerns over increased barriers to trade and trade disruption resulting from measures taken after 9/11 and 3/11. The situation is developing in a non-tariff technical barrier and is causing damage in developing and transitional countries, in that they are not able to respond in a timely fashion and not able to conform to the new security standards. Such security measures ignored trade facilitation and affected the ability of developing nations to trade with the richer nations of the world. In effect, there is an economic penalty for not being part of the current trade security initiatives. On the whole, the global economy could suffer if no reasonable trade security solution coupled with trade facilitation is found.

3. The EU is taking action toward enhancing trade security while improving trade facilitation

The EU has not ignored the complex new trade security/trade facilitation challenges. Preparatory actions have been taken inside EU but also on a regional scale. First, discussions have begun already on the implementation of advance cargo information similar to the U.S. 24-hour rule. The EC published a communication on a simple and paperless environment for Customs and trade and on the role of Customs in the integrated management of external borders on 24 July 2003. One element of this proposal is the establishment of a system where pre-arrival declarations have to be submitted to EU Customs not less than 24 hours before the goods arrive in the EU, similar to the U.S.

Customs 24-hour rule. The advanced collection of the information is necessary to support security controls to be carried out outside the EU Customs area of control where in addition, co-ordination with the external Customs administration is required.

Second, an expected trade security initiative that eventually would ensure smooth trade for legitimate traders is the introduction of "safe actors" or "authorized economic operators" certifications. This initiative is on the EU agenda. Related concepts like "regulated agent" and "known shipper", part of the initiative, would function similar to the U.S. C-TPAT qualification. "Authorized operators would receive trade facilitation and simplification in return for their meeting predetermined criteria which ensure proper and secure conduct of their logistic operations". Still, one has to keep in mind that even in the U.S., where the C-TPAT is functional, there is a difficulty to use specific benchmarks for the qualification process. The EU would have to consider and prepare qualification benchmarks in close collaboration with the industry. An audit process is a necessary requirement in the application of proper benchmarks.

Third, the EU-U.S. Container Security Agreement (signed 22 April 2004) can be viewed as a potentially positive development for both parties. With this agreement, the gain is brought by the exchange of technical information.

International organizations such as ISO, UNECE and WCO are actively participating in recommendations, guidelines and standards that will contribute to secure but also facilitated trade. The WCO is working currently toward common Customs data standards (within the project entitled WCO Customs Data Model) that will have global benefits. This is a clear example of an initiative going both in the direction of security enhancement and also trade facilitation.

Another initiative, New Computerized Transit System, uses a common dataset for transit cargo movement and is currently being implemented by 19 European countries. When this system is fully in place, carriage of goods in transit across the EU member States' territory will be processed electronically and controlled by electronic means. The Customs officers have a possibility to observe the carried cargo in real time and the traders will need to spend less time at the Customs, as transit declarations will be submitted by using

automatic data processing means. There is a definite opportunity to use the same data for security purposes.

New concepts are being explored for the reorganization and security of the entire supply and trade information chain. In the effort for harmonization and standardization, WCO has drafted the Integrated Supply Chain Management Guidelines (Draft) – actually a WCO supply-chain security approach. Additionally, the "Single Window Filing" concept (a single gate for exchanging information with and acceding to different government agencies) is seen as essential for enhanced trade facilitation and security. Furthermore, it is an important and commonly held view that the involvement of Customs is critical for the information processing and validation activity. The Single Window Filing is on the UNECE agenda.

In parallel with all these measures, new technologies, and specifically container security technologies, have been developed at the initiative of the private sector. One such example is the smart container technology incorporating anti-tampering, intrusion and condition detection, tracking, communication and reporting elements that should give supply chain stakeholders a real picture of the location and status of their shipments, while at the same time giving carriers better control of their shipping containers.

The benefits for trade security and trade facilitation of such technologies would come from:

- Fewer delayed and misrouted shipments
- Improved just-in-time reliability
- Reduced inventory
- Better container, chassis, and terminal efficiency
- Deliveries according to order
- Reduced theft and insurance costs, reduces smuggling
- Reduced vulnerability to container-borne terror attack.

4. Further involvement from the EU is needed

The EU recognizes that there are still many gaps to be filled in with respect to security. In late December 2003, the Directorate of Maritime Transport and Intermodality under the EC Directorate-General for Energy and Transport identified three key risk categories with respect to EU transport security:

- Threats to key transport infrastructure
- No common security standards
- No coordination or control of national transport activities

By 2010, the European transport infrastructure will consist of 78,200 kilometers of roads, 78,000 kilometers of railways, 330 airports, 270 international airports and 210 inland ports.

It is widely accepted that the transport infrastructure is only as secure as its weakest link. Often, nodes where cargo changes mode of transport present vulnerable security points that should be addressed in coordination with the directives on enhancing port security. In the preparation of a European wide "transport infrastructure security plan", one should consider such weak links (reviewed at regular intervals) and should establish an adaptable response plan connected with the different threat alert levels. An emergency response plan is critical.

Furthermore, one significant EU coordinated activity is the standardization of trade security and transport security related activities. In order to protect the whole transport chain, it is necessary to ensure that all transport service providers operate to agreed standards.

The international standardization activity started with the 1 July 2004, IMO ISPS code (securing ship and port infrastructure) and is expected to continue toward intermodal transport. The next step is drafting the inland security code across all modes of transport (rail, road, waterborne and aviation). Where standardization is concerned it is worth considering the need for initial market acceptance of standards before these are formally implemented in codes and laws – this requires the necessary collaboration to be created between the government and industry and among business community partners as presented in figure 1.

The coordination of the required infrastructure security activities (ports, airports, inland container depots, rail yards and intermodal nodes) is essential. The new security initiatives must be compatible with the ones already in place for ports and airports. The coordination of the different government organizations and agencies and private companies implicated in transport related activities is an important issue for the EU.

5. Barcelona Treaty for EU-MED Free Trade Area – preparing for a different enlargement

The Barcelona Treaty of 1995 addresses the EU-Mediterranean partnership. This treaty is relevant for the present analysis because it demonstrates the need for the EU to prepare for the upcoming EU-MED Free Trade Area. The 12 Mediterranean partners who are parties to the agreement are situated in the Southern and Eastern Mediterranean.

The treaty implies the dismantling of Customs duties among the members by 2010, through the progressive establishment of a free trade area between the EU and its Mediterranean partners and among the Mediterranean partners themselves. This free trade area is designed to link the 25 EU member States and the 12 Mediterranean partners. The EU-MED Free Trade Area foresees free trade for manufactured goods and progressive liberalization of trade in agricultural products. At a later stage, together with EFTA and Central and Eastern European candidate countries for EU enlargement (CEECs), this free trade zone is expected to include some 40 States and 600-800 million consumers, i.e. one of the world's most important trade blocks.

Along with the clear benefits there are also challenges especially in the preparation for the EU-MED Free Trade Area. Again, the security is one of the key issues to be addressed. One of the immediate effects of the new partnership would be the moving out of borders, again with all the foreseeable but also unforeseen implications. What is being experienced now with the EU-25 would have to be more or less iterated on a larger scale and in a different context. Securing the new longer and sometimes riskier borders implies a significant challenge.

It is foreseeable that Advance Cargo Information and information-sharing systems will have to be implemented both by the EU and by the new

Mediterranean basin partners for the secure and efficient operation of the trade security and the free trade mechanism. On one hand this involves investments, training, and collaboration with the EU and assistance from the EU.

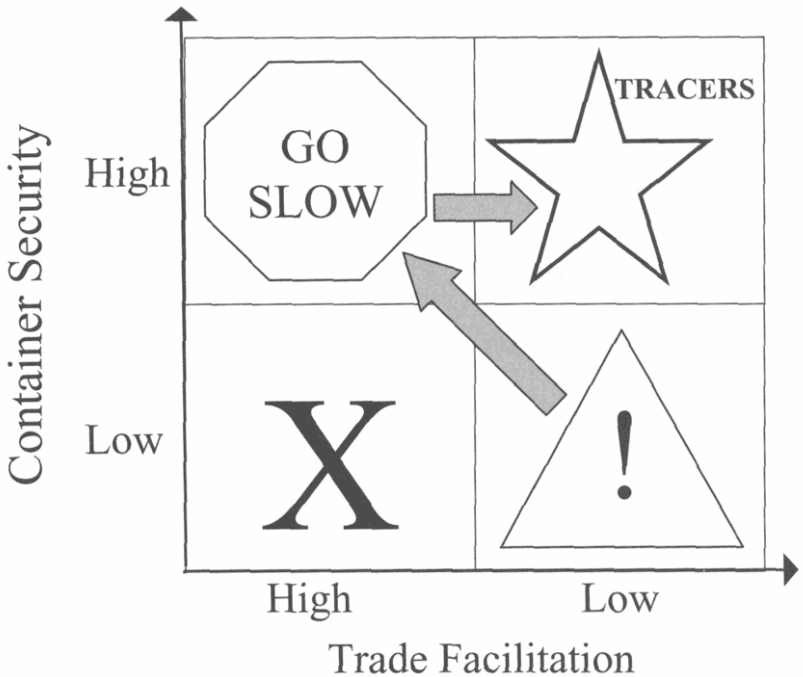
On the technical side, many preparations are needed. Some of the WCO initiatives support smooth integration like the WCO "data model" and the unique Consignment Reference – but are these sufficient?

6. The ultimate goal being trade facilitation within a high-security trade environment – the industry is responding

Figure 2 below represents the evolution of the trade facilitation and trade security. The four frames represent different facilitation/security scenarios. The Low Facilitation + Low Security is a lose-lose scenario. In the case of the second scenario, High Facilitation + Low Security, the facilitation is positive for business, but represents a situation where there are only basic security measures. This is no longer appropriate in a post-9/11 trade environment. The third and next stage scenario, High Security + Low Facilitation, represents the immediate U.S. reaction following the 9/11 attacks, slowing and "handicapping" the economy. In this scenario the business communities and the general economy are negatively impacted while consumers bare the cost increases. The fourth (target) scenario, High Facilitation + High Security, is the ultimate win-win scenario, but it requires significant effort to achieve. This is the focal point of industry partnerships.

Several industry initiatives – including the Innovative Trade Network – have been started to combine trade facilitation and trade security. They share the goal of to creating the infrastructure and the business model to allow all nations, ports, technology providers, and logistics providers to interact on a level playing field. These initiatives can improve economics while addressing security issues associated with commercial shipping. It is crucial that companies work internationally with Governments, agencies and industry stakeholders to create end-to-end global supply-chain systems – from manufacturer, to ports of entry, to consumers – that focus on sound business models, facilitate trade and serve as catalysts for improved security measures.

Figure 2: Trade facilitation vs. container security measures



7. Characteristics of an optimal solution

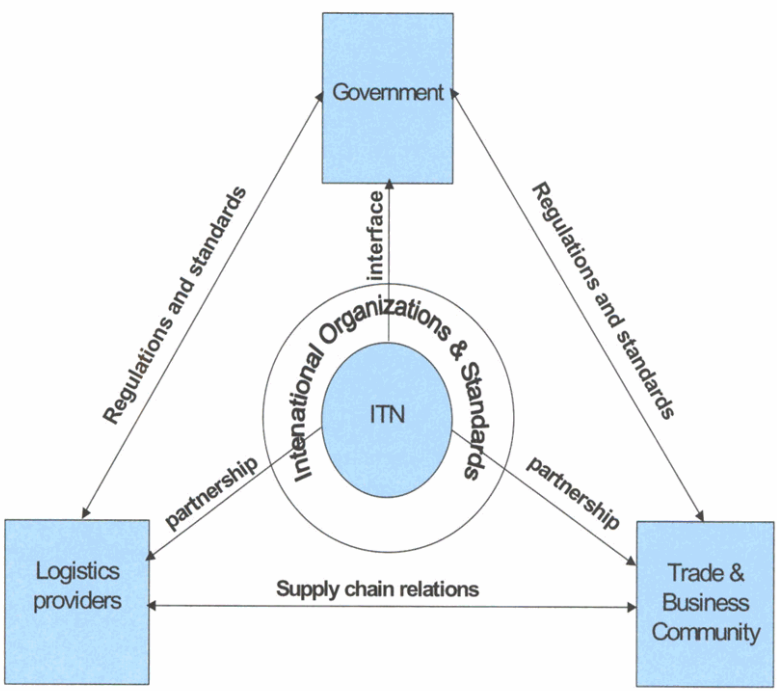
An optimal solution is one which secures the international trade process in a way that can be adapted to the security risk level with limited impact upon trade facilitation. The end-to-end supply-chain security solution (from order to delivery) integrates, among others:

- Validation of container contents prior to sealing
- 24-hour accurate advance manifest information
- Validation and monitoring of containers in transit
- Detection and reporting of tampering
- Data clearinghouse accessible to all end-users
- Accurate and timely cargo information

Such initiatives typically imply data-sharing and it is essential to have clear rules regarding the property and the disclosure of such information.

- The information providers are owners of the data and decide where it goes and who has access
- The risk analysis by the authorities is based upon the information provided (or not provided) directly affecting the "amount" of facilitation that will be granted.

Figure 3: How to provide an interface between logistics providers, the trade community and government laws and regulations



Part of the analysis is the comparison between different data items. The information model is based upon the principle that a stakeholder in a trade transaction always has some information that he will want to give and hold as true. For example the importer will always give the true point of entry into the importing country and likewise the exporter will give the true port of loading of his shipment. This should be correlated with what the carrier has provided in his manifest.
The benefits of common industry initiatives – based on international standards – are as follows:

- They represent a global solution with significant benefits for emerging and developed economies;
- They represent an open platform for all stakeholders;
- They provide proven test bed for trade security technology implementation;
- They represent a solution that enables transatlantic trade security and trade facilitation cooperation; and
- They will address trade security and trade facilitation for the EU-MED Free Trade Area and beyond (2010+).

These industry solutions are dependable, open (but secure) platforms allowing access to all authorized users and stakeholders, as opposed to the proprietary technology solutions which require all to "sign up" and "pay up", and strike the balance between trade security and trade facilitation.

Trade facilitation and security "could" go hand in hand when efficient, co-ordinated measures are taken and when the trade community is motivated to cooperate. The industry is prepared to address these issues and several industry solutions demonstrate specifically that functional solutions exist and are ready to be implemented on a larger scale. Private industry has "answered the call" with innovation and ingenuity.

8. Conclusions and recommendations

This paper has introduced innovative business solutions for trade security and trade facilitation. These solutions meet the needs of Government, businesses and the public. Additionally, this paper addressed different aspects of the EU enlargement, free trade and trade facilitation in a secure environment. The paper described the implications for the future trading environment, the challenges of securing and facilitating trade, implications of the recent EU enlargement and other events impacting trade (e.g. the EU-MED 2010).

Clearly, two different processes have to be coordinated at the EU level and internationally – these are the security process and the facilitation process. The two must go hand in hand. Efficient data systems, advance cargo information, and authorized economic operators are all solutions working for both processes. These are some of the solutions that are being considered by the EU. However, much remains to be done in the direction of securing transport infrastructure, standardization and transport activities coordination.

Dealing with the sensitive trade security/trade facilitation co-ordination can be sometimes complex and the immediate post-9/11 events show that the immediate security measures taken have slowed the international flow of trade, with a serious economic impact especially for developing and transition nations.

The public-private partnership is necessary in order to develop trade facilitation solutions within the security environment.

In this situation, it is necessary to develop industry solutions that create the infrastructure to allow all nations, ports, technology providers and logistics providers to interact on a level playing field that improves economics while addressing security issues associated with commercial shipping. Together, companies need to work in partnerships with international organizations, Governments, agencies and industry stakeholders to create global end-to-end supply-chain systems – from manufacturer, to ports of entry, to consumers – that focus on sound business models facilitating trade and serving as catalysts for improved security measures.

From the analysis presented we may conclude that these industry initiatives can succeed to the extent that they:

- Bring different businesses together, join complementary competences and expertise and create innovative solutions for trade;
- Incorporate some of the latest container security technologies and the best practices in supply chain security management to create a complete end-to-end supply chain security solution;
- Work to meet the needs of government, businesses and the public;
- Encourage the business community to provide security risk assessment information;
- Support the development of recommendations for harmonized government practices and standards;
- Are based on recommendations by international organizations (e.g. UNECE, WCO) that reflect new information technology developments.

The EU should consider collaboration with supply-chain security providers at each step in the process of defining the trade security policy for the enlarged EU. The integration of trade policy with private sector considerations and information technology requirements is clearly a key part of an integrated information technology solution that enables complementary trade facilitation and trade security. In the final analysis, coordination thus becomes an important issue for the EU in terms of trade policy, trade facilitation and trade security.



Integrating Regional Markets: Promoting Competitive, Sustainable Agriculture and International Food Supply Chains

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Chapter 3.1

Implications of EU Enlargement for Agricultural Trade

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The agricultural dimensions of the EU enlargement of May 2004 are well known. The EU population increased by 28 per cent, arable land area by 38 per cent, and livestock output by about 20 per cent. Economic reform during the 1990s transformed the volume and mix of the EU-10 production, consumption and trade. Agricultural production fell, by up to 30 per cent in many countries, as the heavy State supports to farm production under the centrally planned regimes were removed, markets in the EECCA disappeared, and the terms of trade moved unfavourably against farmers and it has taken time to replace the input supply and marketing chains disrupted by the restructuring of farms (Pouliquen, 2001; Leifert and Swinnen, 2002).

1. Pre-accession trade relations

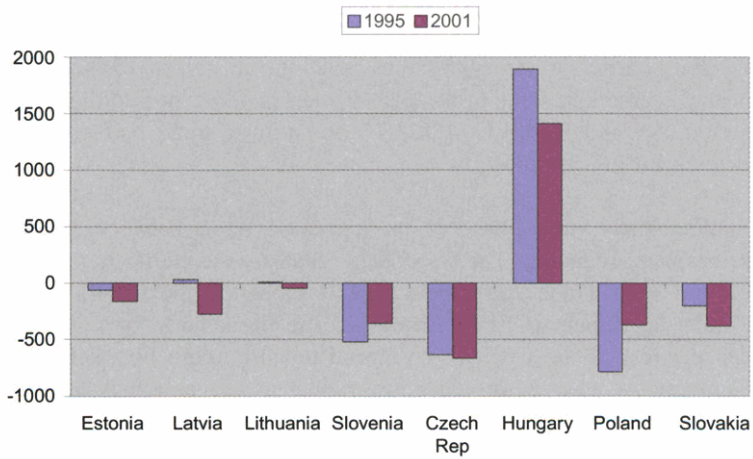
In the EU-10, the share of agriculture and food exports in total exports has been declining since the early 1990s. The shares are highest for the Baltic countries (12.3% for Lithuania in 2001) with Poland and Hungary around 7-8 per cent. The share of agro-food imports in total imports showed some increase in the mid-1990s, but has since begun to decline. Shares are again highest in the Baltic countries (Latvia has the highest proportion at 12.8%). Among the EU-10, only Hungary was a net exporter position of agri-food products (figure 1). For the eight larger EU-10 countries (excluding Cyprus and Malta), the region was self-sufficient in food in 1994. A large deficit of €1.9 billion opened up in 1996, and the deficit fluctuated around €1.5 billion during the remainder of the 1990s (figures from OECD, 2002).

Table 1: Basic indicators of the EU-10, 2001

Country	Population	Per capita GDP as per cent of EU average	Agricultural land	Arable land	Agricultural share of GDP	Agricultural share of employment
	(thousands)	*(percentage)*	*(thousands of hectares)*	*(thousands of hectares)*	*(percentage)*	*(percentage)*
Cyprus	790	83	117	72	4.0	4.8
Czech Republic	10,2260	61	4,278	3,076	4.2	4.6
Estonia	1,337	37	1,433	1,120	5.7	7.1
Hungary	9,917	52	5,865	4,614	4.3	6.1
Latvia	2,406	30	2,480	1,841	4.8	15.1
Lithuania	3,689	28	3,487	2,930	7.2	16.5
Malta	392	n.a.	10	9	2.6	2.3
Poland	38,577	38	18,392	13,974	3.8	19.2
Slovakia	5,403	50	2,450	1,450	4.5	6.3
EU-10	74,796	n.a.	38,479	28,496	n.a.	n.a.
EU-15	375,346	n.a.	142,614	74,470	1.5	4.7

Source: Cochrane, 2004b.

Figure 1: Agricultural and food trade balances in the CEECs in 1995 and 2001



Source: OECD 2002. Figure for Slovakia is for 2000.

Prior to accession, the EU-10 already had significant trade links in agri-food trade with the EU, which accounted for around 50 per cent of the exports of Poland and Hungary in 2001 (see annex, table 1). Although the EU market is becoming more important for the Baltic countries, its share of the agri-food exports of the other EU-10 countries has – however – been falling. There is also a clear trend for the importance of the EECCA as an export market to decline, while inter-CEEC trade, already important for the majority of countries, has been growing over time.

The EU signed a succession of agreements during the 1990s designed to promote integration with the EU-10. Trade protocols attached to Association Agreements provided a means for steadily increasing mutual market access, although agricultural products were included only at the later stages. In 2000, the EU signed "double zero" agreements with all the candidate countries. These provided duty-free quotas for pork and poultry trade and duty-free trade for a number of other goods. Tariff-rate quotas opened for some agricultural products under these agreements were increased from July 2001. Further tariff concessions for processed products were extended at various times between August 2001 and February 2002. These were followed by the "double profit"

agreements signed in 2002 which opened duty-free quotas for wheat, corn, beef and dairy products excluded from the first round of agreements, and which allowed nearly free trade in fruits and vegetables. At the same time, progress was made in reducing and removing TBT and sanitary and phytosanitary barriers to trade which restricted the ability, for example, of milk and meat processors in some of the EU-10 countries to export to the EU during this period. So, much of EU-10/EU-15 agricultural trade had already been liberalized prior to May 2004.

Simultaneously, trade barriers on agri-food trade between the CEECs themselves were reducing. The three Baltic States were members of the Baltic Agricultural Free Trade Agreement (BAFTA), while the Central European Free Trade Agreement (CEFTA) provided the framework for regional trade between the rest of the CEEC. The trend towards more liberal trade under these agreements was occasionally interrupted as Governments reintroduced import tariffs and other trade barriers as a result of import surges from neighbouring countries.

2. Accession arrangements

The EU first set out its accession strategy in the Agenda 2000 plan adopted by the Berlin European Council in 1999. This was based on a two-stage strategy, with an initial six CEECs expected to join in 2002. Under the financial framework, sums were allocated for regional development and agriculture for the five-year period 2002-2006. Importantly, no provision was made for the extension of direct payments to farmers in the EU-10. The then candidate countries began the process of adopting the *communautaire acquis*, a complex process of planning, screening and reporting on their progress in implementing the legislative changes and introducing the institutional structures to implement EU agricultural policy. This has been a massive effort, including the establishment of financial controls and databases and the management of border controls, animal identification and land parcel registration essential for the operation of the Common Agricultural Policy (CAP). The eligibility of the CEE countries for support under the CAP instruments, including issues such as quota levels and reference quantities, was left for negotiation at the very end of this process (Jensen and Frandsen, 2003).

In October 2002, EU leaders reached agreement on a financial ceiling for CAP market expenditure for the medium-term. In the Agenda 2000 package, it was agreed to stabilise CAP market expenditures (excluding rural development) at €40.5 billion (at 1999 prices) over the period 2000-2006, plus 2 per cent annual allowance to adjust for inflation. This agreement was extended in October 2002 to cover the period from 2007 to 2013, but with a lower inflation adjustment figure of 1 per cent. This then set the framework within which the EU had to finance the extension of the CAP to the EU-10.

In March 2002, the EC proposed a comprehensive financial plan for the agricultural aspects of enlargement. The CEECs never accepted their exclusion from direct payments. The Commission plan accepted this position but met the financial constraint by proposing a long phasing in of direct payments. These would be set initially at 25 per cent of the EU level in 2004, gradually increasing over a 10-year period to parity. The plan also set out the Commission's views on the appropriate levels of reference quantities, quotas, reference yields, etc. These were generally related to recent production levels in the CEECs, in contrast to the proposals of the CEEs themselves, which tended to be based on the higher levels of output before transition began and the presumed potential for higher output which existed.

In November 2002, the EU introduced the idea that CEECs would be permitted to "top up" their direct payments from national budgets, as well as using funds being made available under rural development programmes. This would permit payments up to 40 per cent of the level of payments to farmers in the existing member States in the first year, with gradual increases thereafter. This was prompted in part by the realization that some of the EU-10 could otherwise become net contributors to the EU budget immediately after enlargement. Further concessions were made at the Copenhagen Summit in December 2002 at which the final agreement was reached, where the maximum allowable proportion of existing EU payment levels was raised to 55 per cent in the first year. CEEs were offered a simplified implementation scheme for direct payments that was not tied to actual production at farm level, and were not required to introduce set aside, at least for a limited period after accession. Quota and reference quantity levels were also bargained upwards in the final negotiations, but remained well below what the EU-10 had originally sought.

3. Implications of the 2004 enlargement for agri-food trade policy

Although trade integration between the EU-15 and the EU-10 had already advanced quite far under the Europe Agreements, some important changes took place on 1 May 2004. All remaining tariffs and export subsidies were eliminated in addition to non-tariff barriers on internal trade within the EU-25. These included remaining tariffs on trade between the CEECs themselves. Actions now sometimes taken by CEE Governments will no longer be possible. These include imposing increased import duties and minimum import prices, enhancing export subsidy programmes and tightening veterinary checks as a way of relieving import pressure on domestic markets. Because of food safety concerns, a special "safeguard clause" in the Treaty of Accession (Article 38) provides the EU with powers to seal off a country if a food safety problem occurs. Such measures can be taken up to three years after accession and may remain in force after this period. Transitional periods are in place for some food processing plants to give them time to meet the quality and hygiene standards demanded by EU legislation. During this period only sales on the domestic market will be permitted.

Enlargement also brought important changes in the external trade policy of the CEECs. The EU-10 aligned their external border protection on the EU Common External Tariff. They also took on the obligations of the EU preferential trade regimes, including, in particular, duty-free access for the least developed countries under the "Everything But Arms" scheme. Like all WTO members, most of the EU-10 had negotiated schedules of commitments in the Uruguay Round Agreement on Agriculture. In general, bound duties were set at relatively high levels, although the rates applied in practice were much lower. A particular instance is Romania, which negotiated average bound tariffs for agri-food products of 143 per cent, compared with the Czech Republic average of 18 per cent (Chevassus-Lozza and Unguru, 2001).

While, overall, adoption of the Common External Tariff implied a lowering of the weighted average of the tariffs applied to third countries by the EU-10, that was not necessarily true for all countries and commodities. Chevassus-Lozza and Unguru, in their analysis of four countries, found that, for Poland and Hungary, the adoption of the EU tariff would diminish tariff protection while the opposite would be the case for the Czech Republic and Slovakia.

EU enlargement also meant that the candidate countries' health, safety, and related standards have to be harmonized with EU norms. This process is, on balance, favourable to third-country firms which sell to the EU and thus already meet EU standards. Prior to enlargement, a firm which exported a food product approved in the EU could find that it did not meet the Czech standard, hence that it could not export the same product there. Not having to design, test, and certify products for small national markets in Central and Eastern Europe will lower costs and open markets that otherwise might be too small for some third-country exporters to tackle. The EU enlargement also brought acceptance by the EU-10 of EU non-tariff barriers to trade, such as EU directives regarding genetically modified organisms and the ban on imports of hormone-treated beef. The EU also currently bans all poultry meat imports from the United States owing to a ban on treating carcases with chlorine, which the United States exported to Poland and the Baltic States (Cochrane, 2004a). There are swings and roundabouts here, because the EU-10 gave up previous national regulations that may have been more restrictive on some issues than EU law.

4. Price changes and supply response following enlargement

In assessing the effect of EU enlargement on agricultural markets, one must first examine the effect on price and production incentives for farmers in the CEECs. Conventional wisdom had been that support prices in the CEECs were considerably lower than those in the EU-15, with the implication that enlargement would bring a significant boost in the profitability of farm production. However, price levels in the EU-10 had been converging steadily on the EU price level for a number of years, and for a number of reasons:

- Changes in exchange rates meant that the currencies of the candidate countries gradually strengthened against the euro.
- CAP reform under Agenda 2000 meant reduced EU intervention prices for arable crops, beef and sheepmeat.
- CEEC Governments during the 1990s deliberately began to align their prices with those in the EU as part of their preparations for EU membership.

- For many products, price gaps in the 1990s reflected quality differences rather than policy differences. For example, prices for pork and beef in the EU are reported for the three top grades in terms of lean meat content, whereas CEE statistical offices have historically reported average prices for all grades. As meat quality improved and more beef and pork enters the higher grades in the CEECs, so their average prices have converged on EU levels (Cochrane, 2004a).

However, important variations existed at the individual country and commodity level. For example, in Poland, wheat farmers received higher support prices than in the EU, while Slovenian farmers also had high levels of protection for both crop and animal products.

Production incentives are also affected by direct payments policy. Direct payments to farmers in the CEECs were much less important than in the EU-15 largely because of budget constraints in the former. The extension of the Agenda 2000 levels of direct payment, particularly when the simplified area system came to an end in 2009 and payments were eventually coupled to production, could have provided a powerful incentive to increase production. However, the CAP reforms approved in June 2003 will convert these payments to a single whole-farm payment between 2005 and 2007, so that they will remain decoupled from production decisions. The new payment will not differ very much from the simplified area system currently in place in the CEECs. There is still debate on the extent to which these payments can be considered decoupled, given that they remain linked to the use of land. Thus, some boost to production arising from their extension to farmers in the CEECs should probably be expected. Because of the lower reference yields and also the phasing in of the payments over 10 years, the per hectare payments received in the CEECs will initially be about one quarter of those received by the average EU farmer. Payments, of course, will vary by country and by farm size (Cochrane, 2004a).

Another factor likely to limit supply response in the EU-10 is the additional burden of meeting food safety and production process standards and the high cost of compliance. Grain producers will have to meet minimum quality standards to receive the EU price. Livestock farmers will have to observe animal welfare regulations and follow the record-keeping requirements of the EU. These measures will increase production costs and erode the net returns of producers (Cochrane, 2004a).

5. Factors influencing trade flows over time

On accession, the EU-10 benefited from an enhanced rural development policy with increased funding from the EC. This funding was directed to assisting countries to meet higher EU food safety, quality and environmental standards; restructuring the farming sector towards more viable farming, particularly in the livestock sector; reducing the dependence on semi-subsistence farming; and helping to create alternative non-farm employment opportunities in rural areas. In introducing these programmes, the EU-10 benefited from the experience gained through SAPARD, the EU instrument to assist candidate countries. It took a considerable amount of time for the candidate countries to successfully set up mechanisms to disburse funds under the SAPARD programme. Only by the end of 2002 had all 10 eligible countries fulfilled the conditions necessary to apply the instrument. Although this meant that there has been a delay in disbursing the money set aside under SAPARD, it now appears that there is a substantial pipeline of projects that will enable the EU-10 to draw effectively on this funding.

Table 2: Financial allocations for rural development programmes, in millions of euros

	2004	*2005*	*2006*	*2004-2006*
Cyprus	22.5	25.1	27.2	74.8
Czech Republic	163.3	182.0	197.5	524.8
Estonia	45.3	50.4	54.8	150.5
Hungary	181.2	201.9	219.2	602.3
Poland	862.4	961.0	1 043.0	2 866.4
Slovenia	84.7	94.4	102.5	281.6
Lithuania	147.3	164.1	178.1	489.5
Latvia	98.7	110.0	119.4	328.1
Slovakia	119.5	133.1	144.5	397.1
Malta	8.1	9.0	9.8	26.9

Source: Revised Commission decision 29 December 2003.

The need to meet all EU standards and compete in the Single Market brought significant pressure for restructuring CEEC agriculture and food processing. At processing level, significant investments are required to upgrade equipment, introduce grading requirements and meet hygiene standards. This may encourage the emergence of larger units, with the danger

that too much concentration in the industry could lead to excess market power (OECD, 2002). Also of importance are the rapid changes in the food retail sector in the EU-10. Leading Western European supermarket and hypermarket chains, such as Metro, Carrefour and Tesco, have increased their presence in the region. The emergence of larger hypermarket chains has eaten into the smaller retailers' market share, although outside of the major towns and cities, the food retail sector remains undeveloped. Farmers may suffer if the number of purchasing outlets for crops or livestock in a particular region becomes very low, while food processors will face a decreasing number of major buyers for their output. This raises the importance of an effective competition policy across the region.

Foreign direct investment (FDI) will also be an important driver of trade flows. Experience suggests that foreign companies have been interested mainly by the prospect of capturing domestic CEEC markets to take advantage of their future expansion resulting from the expected medium-term economic recovery. Foreign investors have favoured subsectors with better prospects for increasing value-added production and that had not been adequately developed before. Subsectors such as sugar and confectionery, milk and dairy products, beverages and vegetable oils, as well as some others (e.g. tobacco industries), received the highest FDI inflows. The impact of FDI on the subsectors that have benefited from it has been significant. It has helped them to achieve qualitative improvements in food processing and marketing, to circumvent the problem of domestic capital shortage. In export-oriented sectors, it has helped to create export capacities and to facilitate market access. In several cases, processors have established new vertical structures, either through buying in or by contractual ties. In this way, the firms have had a considerable impact on the quality and management aspects of agricultural operations. FDI has thus acted to further structural change in agriculture with a view to responding to actual market demand. In other cases, foreign investors have transferred production expertise, thereby ensuring the introduction of improved techniques in raw material production that would otherwise not be accessible to producers.

The focus so far on the impact on the market balances for bulk agricultural commodities overlooks the fact that the most dynamic sector within agri-food trade is likely to be in processed foods. This will be driven by rising consumer incomes in the CEECs and the demand for greater variety. More disaggregated

analysis of the trade experience during the 1990s shows that the sudden increase in the variety of goods available to consumers in the then candidate countries, compared with what was available under central planning, translated into an initial large deficit in differentiated goods, balanced in part by exports of homogeneous commodity products (Pouliquen, 2001). As time moves on, however, we would expect to see an increase in intra-industry trade within food groups as firms in the EU-10 compete increasingly on quality and less on price.

One area where producers in the EU-10 may be able to convert an apparent disadvantage (i.e. low intensity of production) into a comparative advantage and achieve premium prices is by selling some agricultural produce as organic produce. Under the EU 2091/91 regulation, the law on organic standards within the EU, national bodies responsible for organic standards and certification and control of organically produced goods have been set up in most countries. As there is still very little domestic demand for organic produce in the EU-10, organic production will only develop on the basis of export demand in the near future.

6. Conclusion

EU enlargement integrates the agri-food markets of the EU-10 and EU-15 once and for all. It sets in train a process whereby production growth in each country will depend on its underlying comparative advantage within the enlarged EU, rather than being influenced by trade barriers of one sort or another. The immediate impacts of enlargement on agri-food trade were relatively limited due to the gradual integration of agri-food markets under the earlier Europe Agreements. It also reflected the gradual convergence of price levels within the EU-10 to those prevailing in the EU in the years prior to accession. The relatively restrictive allocations of quota and reference quantities to the EU-10, based on recent production levels rather than historic or hypothetical levels, also helped to limit the production impact of membership. Finally, the 2003 CAP reform, by removing the production incentive of coupled payments that had been due to kick in under the pre-reform regime after 2009, limited the market effects of enlargement in the medium term.

With the exception of Hungary, the agri-food trade of all the EU-10 moved into deficit during the 1990s. EU membership helped to reverse this trend but the effects for the main commodity markets were not major. With greater investment in the food processing sector in the CEECs, including foreign investment, greater two-way trade, particularly of processed food products, might take place. The speed at which this occurs will be influenced by whether the EU-10 can make effective use of EU structural fund assistance over the next few years.

Annex

Table 1: Agri-food exports and imports by destination, 1993 and 2001

Agriculture and food exports by destination, 1993

	EU	OECD1	CEECs	EECCA	Other	Total
Estonia	18	0	21	45	17	100
Latvia	10	5	20	66	1	100
Lithuania	16	4	12	66	2	100
Slovenia	36	12	2	5	45	100
Czech Rep.	33	9	32	13	13	100
Hungary	54	na	na.	20	na	100
Poland	58	13	6	18	5	100
Slovakia	16	7	57	13	7	100

Agriculture and food exports by destination, 2001

	EU	OECD1	CEECs	EECCA	Other	Total
Estonia	18	7	24	36	14	100
Latvia	23	13	29	33	2	100
Lithuania	32	12	24	29	3	100
Slovenia	30	4	3	2	61	100
Czech Rep.	24	4	23	5	44	100
Hungary	48	8	31	10	3	100
Poland	48	5	12	20	15	100
Slovakia	23	1	62	7	7	100

Note: 1999 data for the Czech Republic and Slovakia.

Agriculture and food imports by origin, 1993

	EU	OECD1	CEECs	EECCA	Other	Total
Estonia	50	0	5	9	36	100
Latvia	36	11	17	25	10	100
Lithuania	40	24	18	15	4	100
Slovenia	32	19	11	2	36	100
Czech Rep.	44	11	20	1	24	100
Hungary	54	na	na	2	na.	100
Poland	52	20	7	2	18	100
Slovakia	24	10	51	1	14	100

Agriculture and food imports by origin, 2001

	EU	OECD1	CEECs	EECCA	Other	Total
Estonia	52	6	15	7	19	100
Latvia	44	17	30	4	5	100
Lithuania	51	9	27	11	3	100
Slovenia	49	6	16	2	27	100
Czech Rep.	49	8	22	0	21	100
Hungary	47	7	17	2	27	100
Poland	53	7	10	3	27	100
Slovakia	36	4	46	0	14	100

Note: 1994 data for Lithuania; 1999 data for the Czech Republic and Slovakia.

Source: OECD, 2002.

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Chapter 3.2

Facilitating Trade in Agricultural Products in the UNECE Region

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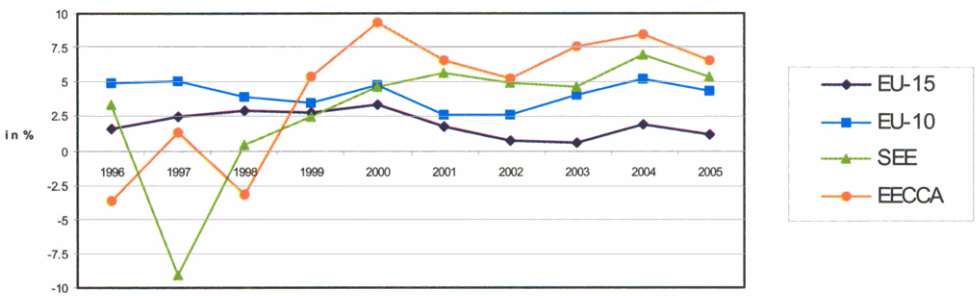
This paper presents an overview of the patterns of trade between the EU and the countries of the EECCA and South-East Europe (SEE) and shows how the process of adopting and implementing a common set of agricultural quality standards will facilitate the integration of their agricultural producers within international food supply chains. To sustain this process, it will be indispensable to increase considerably the technical assistance that is accorded to the transition economies in general, and to their agricultural sectors in particular.

1. Role of agriculture in the transition economies

Gross domestic product (GDP) per capita in the EECCA, SEE and the EU-10 were respectively only about 4 per cent, 9.3 per cent, and 28.8 per cent of that of the EU-15 average at the moment of the 2004 enlargement. There is evidence of a catching-up process, both in the EU-10 and in the EECCA. Figure 1 indicates modestly increasing GDP growth rates per capita over the transition period in the EU-15 (2.4% on average). In contrast, the average growth rate in the period between 1995 and 2001 was about 4 per cent in the EU-10, 2.4 per cent in the EECCA and 1 per cent in SEE. The volatility of the SEE curve is partly due to war and post-war impacts. Higher growth rates in the EU-10 and, to some extent, in the EECCA region could indeed be attributed to

catching up. Nevertheless, at current rates of growth, full convergence would take 40 years in the EU-10 and 50 years in the EECCA.[73]

Figure 1: GDP growth per capita (change over previous year)



Source: UNECE Database.

When the transition to a market economy started in 1989 the agricultural sector in the EECCA and SEE countries had largely similar characteristics. Land was cultivated in large-scale farms that managed thousands of hectares and employed hundreds of workers; this production from the collective sector was supplemented by subsistence farming (see box 1).[74] Product markets and supply chains were controlled by State organizations.

[73] However, the arithmetic is only a rough estimate, as the GDP growth rate for transition countries will decline during the catching up process. Taking into account the volatility of the SEE growth rates, we did not calculate a convergence time frame for this region.

[74] However, in Poland, the model had virtually been abandoned after the Second World War and land was cultivated predominantly by small private farms. In Hungary and the former Yugoslavia, agricultural and food prices were liberalized in the 1960s.

Box 1: Subsistence farming

Subsistence and semi-subsistence farming is still widespread in the CEEC and in central Asia.[75] In general, when own consumption equals or exceeds 50 per cent, agricultural activity is defined as subsistence farming.[76] Whereas subsistence agriculture has been more or less a transitory phenomenon especially, it seems likely to become a constant phenomenon in Central Asia and some countries of Eastern Europe, such as Romania. The numerous very small farms are often held as a security without being put into productive use. In a situation of imperfect markets, uncertainty concerning the quality and quantity of food and scarce off-farm employment opportunities, landholders are reluctant to take the risk of engaging in economic activities elsewhere. These idle land holdings create vast spaces that are underused and unproductive and are therefore often seen as an impediment for economic growth. Policy measures should address the underlying causes of the drift into subsistence farming, in view of its role in stabilizing fragile economies.[77] In some of these countries, the imperfect application of the rule of law and of property rights often makes farmers reluctant to form cooperatives and associations.[78] To conclude, in order to achieve external competitiveness, it is important to promote market oriented agricultural production and export facilities.

As part of the transition to a market economy, the development strategy formulated in the early 1990s envisaged a transformation from collective to individual agriculture. The reforms did not proceed at the same pace across the region, and some countries do not yet permit private ownership of land.

[75] Semi-subsistence farming accounts for no less than 93 per cent of total agricultural value added in the Visegrad countries plus Estonia and Slovenia. Pelkmans and Casey (2003), p. 13.

[76] Balint (2003), p. 11.

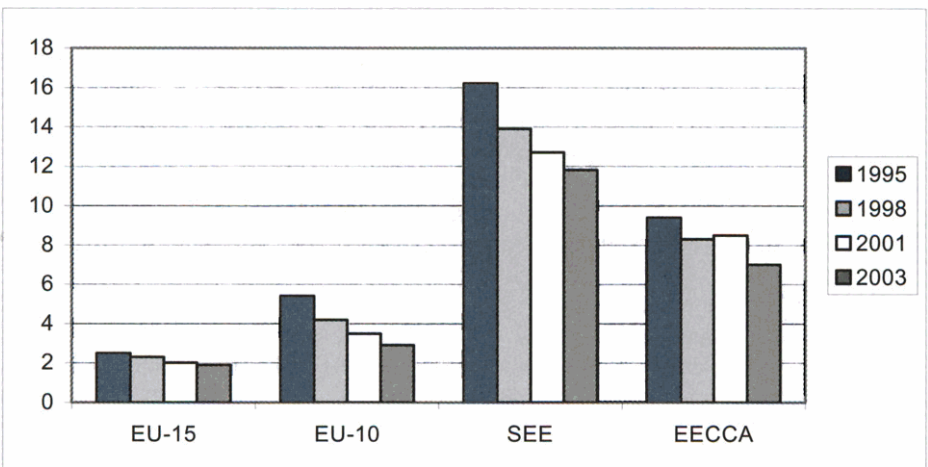
[77] Brüntrup and Heidhues distinguish country external factors (e.g. ecology, climate, history, culture, international environment), farm external factors (e.g. government policies, institutions and markets) and farm internal factors (e.g. factor endowments and farm-family specific characteristics). Brüntrup and Heidhues (2002), p. 8.

[78] Pelkmans and Casey (2003), p. 11.

However, at a general level, economic reform has altered the structure and volume of agricultural production, consumption and trade.

The dominant development was a drop in agricultural output in a range of 25 per cent to 50 per cent in the first years of the transition period before the trend reversed in several countries in the late 1990s.

Figure 2: Share of agriculture in GDP (percentage)

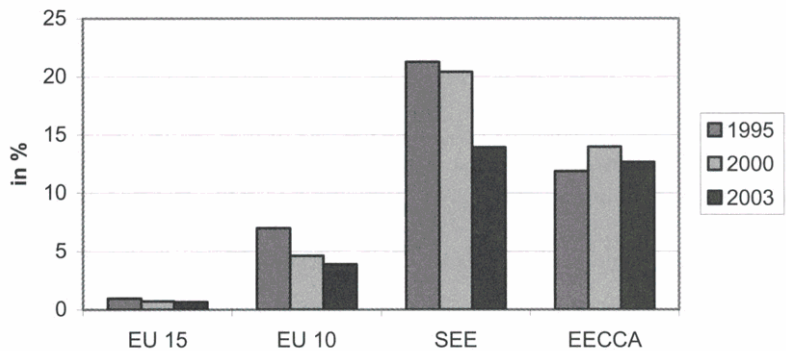


Source: UNCTAD Handbook of Statistics.

This decline in agricultural production – reflected in the fall of the share of agriculture in GDP shown in figure 2 – can be attributed to a number of factors. These include the effective demise of the trade arrangements of the Council for Mutual Economic Assistance (CMEA) in 1991, the disintegration of collective farming, and the fact that in most countries, while the large-scale farms were being closed down, there was – for a wide set of reasons – no concomitant build-up of an efficient private sector.[79]

[79] However, in some countries, such as Tajikistan, Uzbekistan and Albania, the share of agriculture in total GDP has remained nearly constant or even increased.

Figure 3: Share of agricultural in the total employment*



Source: UNECE, Gender Statistics Database

Note: *The following data are missing: for SEE: Bosnia and Herzegovina, Serbia and Montenegro and the former Yugoslav Republic of Macedonia for all the three years; Albania 2003 is not available and was replaced by Albania 2002; for EECCA: data for Kazakhstan, Moldova, Turkmenistan and Ukraine for 1995 are not available; for 2000 the data for Kazakhstan, Tajikistan and Turkmenistan are not available; for 2003, as they were unavailable, the data for Armenia, Belarus, Kazakhstan, Kyrgyzstan and Uzbekistan were replaced with the latest data available while that for Tajikistan and Turkmenistan are missing; for EU-15 the data for the Netherlands for 2003 is missing.

Agriculture's share in employment – after an initial increase – decreased in practically all countries during the transition (see figure 3), but remains high. Currently, the average share of agriculture in total employment in the transition economies varies from 4 per cent in the Czech Republic to 60 per cent in Albania.[80]

2. Trade in agricultural products

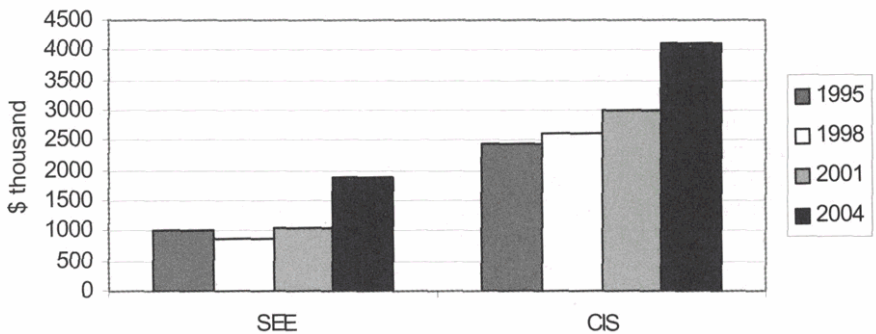
This section presents data on agricultural imports by the EU-25 from the countries of the EECCA and SEE. In the present analysis, the word "agriculture" is defined loosely, to include agricultural produce, eggs, dairy produce, fish and meat, plus wood and wood products and other agro-industrial

[80] Matthews (2003).

products such as oil seeds and oil fruits, sugar, fixed vegetable oils and fats,[81] coffee, tea and spices.

The chart below shows the trend of continuously increasing EU-25 agricultural imports from both the SEE countries and the EECCA. Unfortunately, the data does not stretch beyond 2004, the year of enlargement.[82] Nevertheless, the analysis in section 3 below shows that the enlargement did not imply dramatic changes in market access for these two regions to the EU markets, so it may be anticipated for this trend to continue.

Figure 4: Agricultural imports of the EU-25 from SEE and EECCA



Source: UNCTAD, Comtrade Database.

Focusing on the composition of agricultural trade, wood and wood products represent by far the biggest share of EU imports from the two transition economy groupings (see charts below). In particular, the share of wood and wood products in the total agricultural imports is 58.9 per cent from the EECCA and 32.7 per cent from SEE. For the rest, agricultural imports, especially from the EECCA, show a fairly differentiated picture.

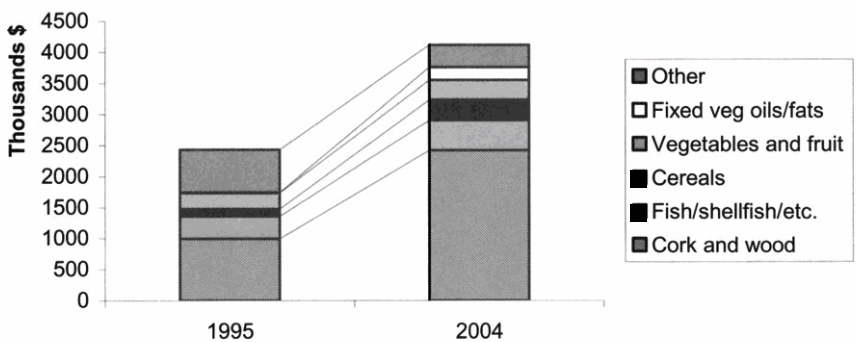
[81] Fixed oils are base oils used in making soaps and lotions.

[82] UNCTAD, Comtrade Database.

Overall imports of agricultural products from the EECCA have risen, on average, by an annual 6 per cent over the period 1995-2004. Exports other than wood and wood products consist mainly of fish and fishery products, cereals, fixed vegetable oils and fats and vegetable and fruit.

The product groups with the highest rates of average annual growth between 1995 and 2004 are: fixed vegetable oils/fats (38.7%), miscellaneous food products (16%) and coffee/tea/cocoa/spices (15.8%). In contrast, the import of other products contracted significantly: dairy products and eggs (-28.5%), rawhide/skin/fur (-15.3%) and processed animal vegetable oils (-7.12%).

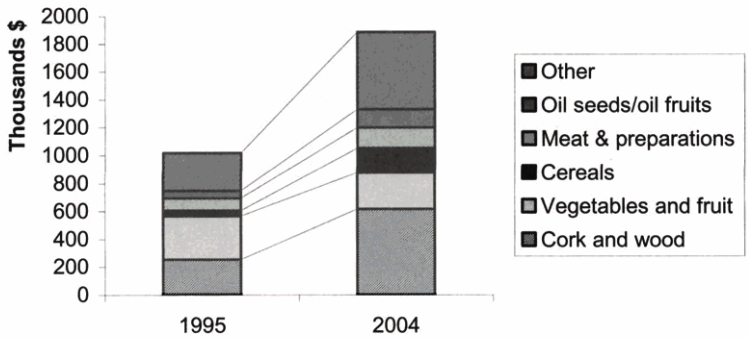
Figure 5: Imports composition from the EECCA



Source: UNCTAD, Comtrade Database.

EU-25 imports from SEE are concentrated, in addition to cork and wood, in the categories of vegetables and fruit, cereals, meat and meat preparations and oil seeds and fruits.

Figure 6: Imports composition from SEE



Source: UNCTAD, Comtrade Database.

Among the 15 categories considered, only two registered a slight decrease in imports between 1995 and 2004. These were vegetables and fruit (-1.9%) and miscellaneous food products (-0.33%). EU imports of all other agricultural and agro-industrial products from SEE increased during the same period. The categories that registered the highest annual average growth rates were sugar/sugar preparations and honey (27.2%) and cereals and animal oils/fats (17.8% and 15.1% respectively).

3. Changes in access to EU markets for EECCA and SEE countries after the 2004 enlargement

As regards non-agricultural products, a free trade area between the EU-15 and the EU-10 had already been established prior to the 2004 enlargement. However, in the agricultural sector, full free trade was only established upon accession. This brought changes for the EECCA and SEE exporters as the EU-10 implemented the EU trade regime, adopted the *acquis communautaire* and

the Common Agriculture Policy (CAP). In general, external tariffs against third countries were higher in the EU-10 than they were in the EU-15.[83]

With the enlargement tariffs were harmonized to the EU level. For example, in Hungary tariffs on agricultural products fell from 31 per cent and in Poland from 34 per cent to the EU-15 level of 16.2 per cent. A few agricultural products, however, currently receive higher protection than they previously did in the EU-10. This was the case for some fish and fish products. In the majority of the EU-10 countries, with the exception of Hungary and Poland, tariffs on fish and fish products were lower than in the EU-15, which are one important export of the EECCA countries to the EU.

The seven countries of SEE are all agricultural exporters, including to Central Europe and the Baltic States. However, as their export pattern consists mainly of Mediterranean products, which are not heavily protected by the CAP, trade restrictions in agricultural products have not imposed significant extra costs on SEE economies upon enlargement.

The EU-10 also terminated bilateral preferential trading agreements with neighbouring countries upon accession to the EU. In particular, regional trade agreements (RTAs) that were terminated include those between Ukraine and the Baltic States as well as Hungary and Serbia and Montenegro. When Romania accedes to the EU in 2007, the agreement between Romania and Moldova will also need to be terminated. Since Ukrainian trade with Lithuania and Estonia is relatively small, the abandonment of those two agreements has not seriously affected overall trade patterns. In contrast, the abolition of the RTA between Hungary and Serbia and Montenegro may be more significant as those countries share a substantial common border and trading activities are historically linked.[84]

The EU's international agreements and unilateral trade preferences applied immediately in the enlarged Union.[85] As regards the countries of EECCA, the

[83] To be specific, on average the tariffs of Estonia, Latvia and Lithuania rose modestly, but average tariff levels in Poland and Hungary (the two largest economies to join the EU) fell significantly.

[84] UNECE (2003b), p. 152.

[85] European Commission (2003), p. 5.

Partnership and Cooperation Agreements[86] (PCAs) – signed between the EU-15 and each country in the EECCA (except Tajikistan)[87] prior to the enlargement – were subsequently extended to include the EU-10. They provide for reciprocal Most Favoured Nation status and for the removal of a large number of quantitative restrictions. Additionally, EECCA countries benefit from the Generalized System of Preferences scheme of the EU.

The EU's relations with the countries of SEE are governed by the Stabilization and Association Agreements (SAAs), which lay out a framework for strengthening the economic ties between the two regions. Under the trade measures introduced by the EU in 2000, the greatest change compared to the previous system was the almost complete liberalization of imports of agricultural products. [88] Few exceptions remain like the preferential quotas for some fishery meat and beverages. A first assessment shows that the SEE has made good use of the preferences and the growth rate of exports from SEE to the EU has been substantial. Since the implementation of the trade measures in September 2001, EU imports from the region rose by 21 per cent. However, the total export level has remained low, corresponding to only about 0.5 per cent of EU imports. Romania – whose GDP per capita and population are roughly equivalent to the combined SEE region – has a share of EU total imports of 1.1 per cent.[89]

4. Agricultural quality standards as a means of facilitating trade in the UNECE region

When economic agents move away from their domestic markets, their success or failure often hinges on how familiar they are with regulations and standards in their export markets. Essentially, the purpose of standards is to protect the health of consumers; to keep research, information and negotiation

[86] The first such agreements were concluded with the Russian Federation, Moldova and Ukraine in 1994. The agreements with Belarus, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan and Turkmenistan followed.

[87] A PCA was initialled in 2003 but it has not yet been signed.

[88] UNECE (2003a), p. 13.

[89] European Commission (2004).

costs low for both processors and consumers; and to safeguard honest practice in the trade of agricultural products.[90]

The benefits of common standards are manifold. In short, standards facilitate trade because all the parties involved in the transaction speak a common language. But many more arguments can be brought forward. First, it is the existence of standards that allows long-distance trade in agricultural products, because the buyer can then buy based on the description of the goods according to accepted standards. Furthermore, a standard can encourage farmers to improve the quality of their produce, especially when the technical description is broken down into different categories: by moving from a class B to a class A, the producer can earn a better return. Finally, standards can reduce waste because when produce is sent long distances and is not marketed for quality reasons, it will spoil.

At the same time, although standards are the expression of a society that cares about the quality of produce, they are often at odds with the needs of societies that are preoccupied with the responsibility of feeding their hungry. For this reason, it is clearly important that standards be developed internationally so that a balance among different sets of interests can be found. It should also be realized that quite often, the existence of more advanced standards on export markets when compared to those applied at home can result in the segmentation of agricultural production, reducing the potential for transfer of know-how. It is nevertheless true that, with time, the better agricultural and husbandry techniques that are required for producing for export markets can increase productivity in production for the home market and hence have trickle-down benefits beyond those that are experienced by the consumers in the export market.

UNECE's agricultural quality standards are widely implemented in international trade and are therefore very important in the operation of the international food supply chain. UNECE has developed 85 standards for fresh fruit and vegetables, dry and dried produce, early and ware potatoes, seed potatoes, eggs, meat and cut flowers. Of these, 36 form the basis for European Union standards, and 52 have been adopted by the OECD and are promoted internationally through their Fruit and Vegetables Scheme. In addition, a

[90] AMO (2003), p. 9.

number of Codex Alimentarius standards are based on UNECE standards for fresh fruits and vegetables.

The 36 EU standards based on UNECE standards cover around 90 per cent of the market volume of products traded in Europe. The texts of these EU standards are almost completely harmonized with UNECE standards and efforts are being made to reach full harmonization. In practice, the EU accepts produce coming from non-EU countries that are marked and controlled according to UNECE standards, for purposes of quality.

The EC encourages EU candidate countries to take part in UNECE meetings on standards development, which has led to the participation of the Baltic States and Bulgaria in recent sessions. The EU has also supported the integration of UNECE standards into the national legislation of the EU-10 by providing those countries with training programmes and consultants.

Because a large proportion of world trade in agricultural products relies on UNECE standards, these standards can contribute to further post-enlargement European integration to the extent they are widely implemented. UNECE can assist by raising awareness of its standards and establishing training programmes and can promote best practices in agriculture that keep both domestic interests and sustainability in mind (e.g. achieving higher quality, smaller scale production to be sold on international markets).

The removal of inefficiencies is particularly beneficial for transition economies for several reasons. First, SMEs, where trade administration accounts for a larger part of total costs, constitute the majority of those countries' business sectors. Also, since labour and production costs in transition economies are far lower than in the EU, even when discounting for travel costs, these countries could have a sizeable competitive advantage, to the extent they are enabled to adopt and implement EU quality standards.

5. Conclusions

Increasing exports of agricultural and food products could – at least in the short term – be an important part of the development strategy for many countries of the UNECE region. This would be particularly true if the boost in exports was accompanied by the adoption and implementation of quality

standards, which could have, via a higher productivity, positive spillover effects to other economic activities.

The performance of exports from the transition economies is in general a positive one. The total exports of agricultural products from the region are increasing, and the range of exported products is expanding.

However, the EU agricultural market is difficult to penetrate and competition is high. Therefore much remains to be done to increase the export potential of the transition economies. Contacts with EU counterparts need to be established, distribution channels must be built up, and investments may be required in order to take full advantage of the improved export possibilities. Further work on export promotion and harmonization of standards also has to be carried out, and trade-related legislation implemented.[91]

Well-focused technical assistance projects could therefore be highly beneficial and could give good returns over relatively little investment. Concrete examples would be:

- Allowing more regular participation of the countries that are not expected to become EU members in the near future in the meetings of UNECE, where agricultural quality standards are discussed;
- Assisting these countries in adopting and implementing harmonized standards;
- Raising the awareness and the understanding of farmers regarding marketing, environmental and packaging requirements; and
- Assistance for capacity-building for trade facilitation and logistics systems, which are integral elements of modern agricultural supply chains.

To the extent that member States put at its disposal the necessary means, UNECE stands ready to take up these challenging tasks, and to provide an open and accessible forum for future policy dialogue.

[91] UNECE (2003c), p. 20ff.

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